SECURITIES AND EXCHANGE COMMISSION

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Unless otherwise noted, each of the following individual Members of the Commission voted affirmatively upon each action of the Commission shown in the file:

MARY L. SCHAPIRO, CHAIRMAN

KATHLEEN L. CASEY, COMMISSIONER

ELISSE B. WALTER, COMMISSIONER

LUIS A. AGUILAR, COMMISSIONER

TROY A. PAREDES, COMMISSIONER

(43 Documents)

Commissioner Walter not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 63992 / March 1, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14278

In the Matter of **Tronox Incorporated,** **Respondent.**	**ORDER INSTITUTING PROCEEDINGS, MAKING FINDINGS, AND REVOKING REGISTRATION OF SECURITIES PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act"), against Tronox Incorporated ("TRXBQ" or "Respondent").

II.

In anticipation of the institution of these proceedings, TRXBQ has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, TRXBQ consents to the entry of this Order Instituting Proceedings, Making Findings, and Revoking Registration of Securities Pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Order"), and to the findings as set forth below.

III.

On the basis of this Order and the Respondent's Offer, the Commission finds:

1. TRXBQ (CIK No. 1328910) is a Delaware corporation located in Oklahoma City, Oklanoma with a class of securities registered with the

Commission under Exchange Act Section 12. As of September 20, 2010, the Class B common stock of TRXBQ (symbol "TRXBQ") was quoted on the Pink Sheets operated by Pink OTC Markets, Inc., had twenty-three market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

2. TRXBQ has failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder because it has not filed any periodic reports with the Commission since the period ended September 30, 2008.

IV.

Section 12(j) of the Exchange Act provides as follows:

The Commission is authorized, by order, as it deems necessary or appropriate for the protection of investors to deny, to suspend the effective date of, to suspend for a period not exceeding twelve months, or to revoke the registration of a security, if the Commission finds, on the record after notice and opportunity for hearing, that the issuer of such security has failed to comply with any provision of this title or the rules and regulations thereunder. No member of a national securities exchange, broker, or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security the registration of which has been and is suspended or revoked pursuant to the preceding sentence.

In view of the foregoing, the Commission deems it necessary and appropriate for the protection of investors to impose the sanction specified in Respondent's Offer.

Accordingly, it is hereby ORDERED, pursuant to Section 12(j) of the Exchange Act, that registration of each class of TRXBQ's securities registered pursuant to Section 12 of the Exchange Act be, and hereby is, revoked.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Aguilar
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9192 / March 1, 2011

SECURITIES EXCHANGE ACT OF 1934
Release No. 63995 / March 1, 2011

INVESTMENT ADVISERS ACT OF 1940
Release No. 3167 / March 1, 2011

INVESTMENT COMPANY ACT OF 1940
Release No. 29580 / March 1, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14279

In the Matter of Rajat K. Gupta, Respondent.	ORDER INSTITUTING PUBLIC ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, SECTIONS 15(b) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940, AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act"), and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act") against Rajat K. Gupta ("Respondent" or "Gupta").

II.

After an investigation, the Division of Enforcement alleges that:

A. SUMMARY

1. This matter concerns insider trading by Rajat K. Gupta ("Gupta"), who on a number of occasions disclosed material nonpublic information that he obtained in the course of his duties as a member of the Boards of Directors of The Goldman Sachs Group, Inc. ("Goldman Sachs") and The Procter & Gamble Company ("Procter & Gamble") to Raj Rajaratnam ("Rajaratnam"), the founder and a Managing General Partner of the hedge fund investment adviser Galleon Management, LP ("Galleon"). Rajaratnam, in turn, either caused the Galleon hedge funds that he managed to trade based on the material nonpublic information, or passed the information on to others at Galleon and caused trades based on the information.

2. Specifically, Gupta disclosed to Rajaratnam material nonpublic information concerning Berkshire Hathaway Inc's ("Berkshire") $5 billion investment in Goldman Sachs before it was publicly announced on September 23, 2008, as well as Goldman Sachs's financial results for both the second and fourth quarters of 2008. Rajaratnam caused the various Galleon hedge funds that he managed to trade based on the material nonpublic information, generating illicit profits and loss avoidance of more than $17 million. In addition, Gupta disclosed to Rajaratnam material nonpublic information concerning Procter & Gamble's financial results for the quarter ending December 2008. Rajaratnam relayed this information to others at Galleon, who caused Galleon funds to trade based on the information, generating illicit profits of over $570,000.

3. In the course of carrying out the insider trading scheme, Rajaratnam informed certain conspirators that he obtained nonpublic information concerning Goldman Sachs from his source on the company's Board. Rajaratnam informed at least one other conspirator that he obtained nonpublic information concerning Procter & Gamble from his source on Procter & Gamble's Board. As set forth below, Gupta was Rajaratnam's source on both companies' Boards and knowingly or recklessly disclosed material nonpublic information to Rajaratnam for use in trading activities.

4. During the relevant period, Gupta had a variety of business dealings with Rajaratnam and stood to benefit from his relationship with Rajaratnam. In addition, Gupta was an investor in, and a director of, Galleon's GB Voyager Multi-Strategy Fund SPC, Ltd., a master fund with assets that were invested in numerous Galleon hedge funds, including those that traded based on Gupta's illegal tips.

5. By virtue of his conduct, Gupta willfully violated Section 17(a) of the Securities Act, and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

B. RESPONDENT

6. *Gupta*, age 62, resides in Westport, Connecticut. From November 2006 through May 2010, Gupta was a member of Goldman Sachs's Board of Directors. During his tenure on Goldman Sachs's Board, Gupta served as a member of the Board's Audit Committee, Corporate Governance and Nominating Committee, and Compensation Committee. Since 2007, Gupta has also been a member of Procter & Gamble's Board of Directors, and has served on the Board's Audit Committee and its Innovation and Technology Committee. Gupta serves on the Boards of Directors of several other public companies and is affiliated with other entities, both public and private. Gupta is a Founding Partner and the Chairman of New Silk Route Partners LLC, an investment firm that was originally called Taj Capital Partners and was founded by Gupta, Rajaratnam, and others in 2006. Gupta holds a Bachelor of Technology degree in mechanical engineering from the Indian Institute of Technology and an MBA from Harvard Business School.

C. OTHER RELEVANT ENTITIES

7. *Berkshire* is a Delaware corporation headquartered in Omaha, Nebraska. Berkshire is a holding company that owns subsidiaries engaged in many business activities. Berkshire's securities are registered with the Commission pursuant to Section 12(b) of the Exchange Act, and its stock trades on the New York Stock Exchange ("NYSE") under the symbols "BRK-A" for its Class A shares, and "BRK-B" for its Class B shares.

8. *Galleon*, a Delaware limited partnership, is a hedge fund investment adviser based in New York, New York. As of March 2009, Galleon had over $2.6 billion under management. Galleon was founded in 1997 and registered with the Commission as an investment adviser in January 2006. In the wake of the October 16, 2009, insider trading arrest of Rajaratnam, Galleon began to liquidate itself and the hedge funds it advised. During the relevant period, Galleon served as the investment adviser for several hedge funds, including Technology Offshore Fund, Technology Partners Fund, Technology MAC Fund, and the Diversified Fund (collectively, the "Galleon Tech funds").

9. *Goldman Sachs* is a Delaware corporation headquartered in New York, New York. Goldman Sachs is a global investment banking, securities, and investment management firm that provides financial services to a client base that includes corporations, financial institutions, governments, and high-net-worth individuals and has a substantial broker-dealer operation. The subsidiaries of Goldman Sachs include broker-dealers and investment advisers registered with the Commission. Goldman's securities are registered with the Commission pursuant to Section 12(b) of the Exchange Act and its stock trades on the NYSE under the symbol "GS."

10. *Procter & Gamble* is an Ohio corporation headquartered in Cincinnati, Ohio. Procter & Gamble is a provider of branded consumer goods products in over 180 countries around the world. Procter & Gamble's securities are registered with the Commission pursuant to Section 12(b) of the Exchange Act and its stock trades on the NYSE under the symbol "PG."

11. *Rajaratnam*, age 53, resides in New York, New York. Rajaratnam is the founder and a Managing General Partner of Galleon, and, during the relevant period, served as Portfolio Manager of the Galleon Tech funds. Prior to founding Galleon, Rajaratnam worked at Needham & Co., a registered broker-dealer, for 11 years, at which time he held Series 7 and Series 24 securities licenses. Rajaratnam obtained a degree from the University of Sussex, England, in 1980, and an MBA in Finance from the Wharton School of the University of Pennsylvania in 1983.

D. ALLEGATIONS

Gupta Disclosed Material Nonpublic Information to Rajaratnam Concerning Berkshire's $5 Billion Investment in Goldman Sachs

12. In September 2008, Gupta disclosed to Rajaratnam material nonpublic information he learned as a member of the Goldman Sachs Board of Directors concerning, among other things, Berkshire's $5 billion investment in Goldman Sachs, which was publicly announced on September 23, 2008. Rajaratnam, in turn, caused the Galleon Tech funds to trade based on the material nonpublic information that Gupta disclosed.

13. Soon after the bankruptcy filing of Lehman Brothers Holdings Inc. ("Lehman") on September 15, 2008 —which sent the financial markets into an unprecedented tailspin — senior management of Goldman Sachs began considering various strategic alternatives as they tried to navigate through the ongoing financial crisis. These alternatives included a potential investment from an institutional investor like Berkshire, and were variously discussed at Goldman Sachs Board meetings and posting calls during the week and a half following Lehman's bankruptcy filing.

14. Goldman Sachs executives continued to explore various strategic alternatives the weekend after the Lehman bankruptcy. The Goldman Sachs Board convened a Special Meeting on Sunday, September 21, 2008. During that meeting, which Gupta attended via teleconference, the Board approved Goldman Sachs becoming a Bank Holding Company. The Goldman Sachs Board was also updated on certain strategic alternatives that had been considered over the weekend.

15. Goldman Sachs CEO Lloyd Blankfein ("Blankfein") had a long-standing practice of informing the Board during posting calls, meetings and phone calls about the then-current financial status of the firm. Goldman's net revenues had been particularly strong in the week leading up to the meeting – despite the fact that the week had begun with Lehman's bankruptcy and that the financial markets were in a general state of turmoil. While the Board's determination to convert Goldman Sachs into a Bank Holding Company was publicly disclosed on the evening of September 21, information concerning Goldman Sachs's strategic alternatives and strong net revenue remained confidential.

16. Telephone records and calendar entries indicate that, on the morning of Monday, September 22 — the day after the Sunday evening Goldman Sachs Board

meeting — Gupta and Rajaratnam very likely had a telephone conversation. Shortly after that conversation, Rajaratnam caused the Galleon Tech funds, which held no preexisting long or short position in Goldman Sachs securities at the time, to purchase over 80,000 Goldman Sachs shares.

17. On the morning of September 23, Rajaratnam placed a call to Gupta which lasted over 14 minutes. Less than a minute after the call began, Rajaratnam caused the Galleon Tech funds to purchase more than 40,000 additional Goldman Sachs shares.

18. A Special Telephonic Meeting of the Goldman Sachs Board was convened at 3:15 p.m. on September 23, during which the Board considered and approved a $5 billion preferred stock investment by Berkshire in Goldman Sachs and a public equity offering. As Gupta knew, Berkshire was one of the most respected and influential investors and its decision to make such a large investment in Goldman Sachs would likely be viewed as a strong vote of confidence in the firm when the information was disclosed to the public. The infusion of a large amount of new capital in the firm also would likely be viewed favorably by investors. Gupta participated in the Board meeting telephonically, staying connected to the call until approximately 3:53 p.m. Immediately after disconnecting from the Board call, Gupta called Rajaratnam from the same line. Within a minute after this telephone conversation, at 3:56 p.m. and 3:57 p.m., and just minutes before the close of the markets, Rajaratnam caused the Galleon Tech funds to purchase more than 175,000 additional Goldman Sachs shares. Rajaratnam later informed a conspirator that he received the information upon which he placed the trades minutes before the close.

19. Goldman Sachs publicly announced the Berkshire investment, along with a $2.5 billion public stock offering, after the market close on September 23. Goldman Sachs's stock price, which had closed at $125.05 per share on September 23, opened at $128.44 per share the following day and rose to a closing price that day of $133.00 per share, a gain of 6.36% from the prior day's closing price.

20. On September 24, Rajaratnam caused the Galleon Tech funds to liquidate the long position they had built on September 23, generating profits of over $900,000.

Gupta Disclosed Material Nonpublic Information to Rajaratnam Concerning Goldman Sachs's Financial Results for the Fourth Quarter of 2008

21. Gupta also disclosed material nonpublic information that he learned during a Goldman Sachs Board posting call about Goldman Sachs's financial results for the fourth quarter of 2008 to Rajaratnam, who caused the Galleon funds he managed to trade based on the information.

22. Goldman Sachs announced negative results for the fourth quarter of 2008 on December 16, 2008, reporting a $2.1 billion loss, its first (and only) quarterly loss as a publicly traded company.

23. Blankfein began to appreciate very early in the quarter that results were going to be poor. About mid-quarter, on October 23, 2008 at 4:15 p.m., Blankfein, Goldman Sachs Chief Financial Officer David Viniar ("Viniar"), and other senior executives at Goldman Sachs conducted a Board posting call during which they informed the Board of the company's then-current financial situation. The daily and weekly profit and loss statements that Blankfein and Viniar would typically rely on as the basis for their presentations to the Board show that the company was then operating at a quarter to date loss of $1.96 per share at the time.

24. Gupta dialed into the October 23, 2008, Board meeting around the time it was scheduled to start and remained on the call until 4:49 p.m. Just 23 seconds after disconnecting from the call, Gupta called Rajaratnam. The call lasted approximately 13 minutes. The following morning, just as the financial markets opened at 9:30 a.m., Rajaratnam caused the Galleon Tech funds to begin selling their holdings of Goldman Sachs stock. The funds finished selling off their holdings — which had consisted of over 120,000 shares — that same day at prices ranging from $97.74 to $102.17 per share. The same day (October 24, 2008), in discussing trading and market information with another participant in the trading scheme, Rajaratnam explained that Wall Street expects Goldman Sachs to earn $2.50 per share but that Rajaratnam had heard the prior day from a member of the Goldman Sachs Board that the company was actually going to lose $2 per share. As a result of Rajaratnam's trades based on the material nonpublic information that Gupta provided, the Galleon Tech funds avoided losses of over $3 million.

Gupta Disclosed Material Nonpublic Information to Rajaratnam Concerning Goldman Sachs's Financial Results for the Second Quarter of 2008

25. Gupta also disclosed to Rajaratnam material nonpublic information concerning Goldman Sachs's positive financial results for the second quarter of 2008, which were publicly announced on June 17, 2008. Rajaratnam caused the Galleon funds he managed to trade based on the information.

26. Approximately one week before the announcement, on June 10, 2008, at 5:41 p.m., Blankfein placed a call to Gupta that lasted more than 8 minutes. The call was one of several Blankfein made to various Goldman Sachs outside directors around the same time that evening. Blankfein's practice was to apprise Directors of the then-current financial status of the firm when he spoke to them.

27. Goldman Sachs's second quarter of 2008 had ended on May 30, 2008. By June 10, 2008, Goldman Sachs's financial reporting team had already compiled and analyzed the quarterly financial data and put together a draft earnings press release that had been circulated to various finance personnel, including Viniar, prior to Blankfein's call with Gupta. The company's financial performance was strong in an extremely difficult environment, and significantly better than analyst consensus estimates.

28. Blankfein knew the earnings numbers (which were positive) and discussed them with Gupta during their June 10, 2008, telephone conversation.

29. On the night of June 10, 2008, at 9:24 p.m., Gupta placed a short call to Rajaratnam's home. The call was the first in a flurry of short calls between the two over an 18-minute span that night, which culminated in a 4-minute call from Rajaratnam to Gupta, at 9:42 p.m. On the following morning, June 11, at 8:43 a.m., Rajaratnam placed another call to Gupta that lasted about 2.5 minutes. Beginning at 9:35 a.m., minutes after the markets opened, Rajaratnam caused the Galleon Tech funds to significantly increase an existing long position it had established in Goldman Sachs shares by purchasing over 5,500 Goldman Sachs June $170 call option contracts (Goldman Sachs's share price had opened at $167.00 per share on June 11).

30. Rajaratnam also caused the Galleon Tech funds to purchase over 350,000 additional Goldman Sachs shares on June 11 and 12, selling only a small portion on June 13.

31. On June 16, after a positive Goldman Sachs earnings preview was issued sending Goldman Sachs's stock price up more than 2%, Rajaratnam caused the Galleon Tech funds to sell the June $170 call option contracts they had purchased on June 11, generating profits of approximately $7 million.

32. On June 17, prior to market open, Goldman Sachs announced its quarterly results. Revenues and earnings per share beat analysts' estimates, and Goldman Sachs's share price opened the day at $185.04 per share — about 1.62% higher than the prior day's closing price of $182.09 per share. After the announcement, Rajaratnam caused the Galleon Tech funds to sell the Goldman Sachs shares they had purchased after Rajaratnam received the material nonpublic information from Gupta on June 10, generating profits of over $6.6 million.

33. The total illicit profits made by the Galleon Tech funds by virtue of their trading based on Gupta's material nonpublic information concerning Goldman Sachs's second quarter of 2008 results exceeded $13.6 million.

Gupta Disclosed Material Nonpublic Information to Rajaratnam Concerning Procter & Gamble's Financial Results for the Quarter Ending December 2008

34. Gupta also disclosed to Rajaratnam material nonpublic information that Gupta learned as a member of Procter & Gamble's Board of Directors about Procter & Gamble's financial results for the October through December 2008 quarter. Rajaratnam then passed the material nonpublic information to his Galleon colleagues, who then caused Galleon funds to trade based on the information.

35. At 9:00 a.m. on January 29, 2009, the day before Procter & Gamble's pre-market quarterly earnings release was issued, Procter & Gamble's Audit Committee, of which Gupta was a member, met telephonically to discuss the planned release. Gupta dialed into the Audit Committee meeting at its scheduled start time and remained on the call for over 19 minutes. A draft of the earnings release, which had been mailed to Gupta

and the other committee members two days before the meeting, stated, among other things, that the company expected organic sales, or sales related to preexisting rather than newly acquired business segments, to grow 2-5% in the fiscal year. This compared negatively to the 4-6% growth the company had previously publicly predicted.

36. Gupta called Rajaratnam in the early afternoon on January 29, 2009. Shortly afterwards, Rajaratnam advised another participant in the insider trading conspiracy that he had learned from a contact on Procter & Gamble's Board that the company's organic sales growth would be lower than expected. In the late afternoon of January 29, 2009, Galleon funds sold short approximately 180,000 Procter & Gamble shares. After Procter & Gamble issued its earnings release in the pre-market on January 30 (the actual release was substantially the same as the draft release Gupta had been provided), Procter & Gamble's stock price, which had closed at $58.22 per share on January 29, opened on January 30 at $56.50 per share. The stock price declined further to $54.50 per share by the close on January 30, down approximately 6.39% from the prior day's closing price.

37. By virtue of their trades, which were based on the material nonpublic information that Gupta provided to Rajaratnam, the Galleon funds generated illicit profits of over $570,000.

Gupta's Fiduciary Duty to Keep Confidential All Material, Nonpublic Information about Goldman Sachs

38. As a Goldman Sachs Director, Gupta had a duty to keep confidential all material, nonpublic information about Goldman Sachs.

39. Goldman Sachs's Corporate Governance Guidelines in effect and applicable to Gupta during the relevant period provided that the proceedings and deliberations of the Board and its committees were confidential. Moreover, non-employee directors such as Gupta were prohibited from speaking on behalf of the company without consulting the Chief Executive Officer.

Gupta's Fiduciary Duty to Keep Confidential All Material, Nonpublic Information about Procter & Gamble

40. As a Procter & Gamble Director, Gupta had a duty to keep confidential all material, nonpublic information about Procter & Gamble.

41. Procter & Gamble's insider trading policy in effect and applicable to Gupta during the relevant period prohibits him from trading while in possession of material nonpublic information concerning Procter & Gamble, or from conveying that information to others, and specifically prohibits use or disclosure of information included in draft earnings reports as subject to the policies' strictures.

E. VIOLATIONS

42. As a result of the conduct described above, Gupta willfully violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in the offer and sale of securities and in connection with the purchase or sale of securities.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate in the public interest that public administrative and cease-and-desist proceedings be instituted to determine:

A. Whether the allegations set forth in Section II hereof are true and, in connection therewith, to afford Respondent an opportunity to establish any defenses to such allegations;

B. What, if any, remedial action is appropriate in the public interest against Respondent pursuant to Section 15(b) of the Exchange Act including, but not limited to, disgorgement and civil penalties pursuant to Section 21B of the Exchange Act;

C. What, if any, remedial action is appropriate in the public interest against Respondent pursuant to Section 203(f) of the Advisers Act including, but not limited to, civil penalties pursuant to Section 203(i) of the Advisers Act;

D. What, if any, remedial action is appropriate in the public interest against Respondent pursuant to Section 9(b) of the Investment Company Act including, but not limited to, civil penalties pursuant to Section 9(d) of the Investment Company Act; and

E. Whether, pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, Respondent should be ordered to cease and desist from committing or causing violations or future violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; whether Respondent should be ordered to pay disgorgement pursuant to Section 8A(e) of the Securities Act and Section 21C(e) of the Exchange Act and penalties pursuant to Section 8A(g) of the Securities Act and Section 21B(a)(2) of the Exchange Act; and whether other appropriate relief should be granted in the public interest, including a prohibition from service as an officer or director of any issuer pursuant to Section 8A(f) of the Securities Act and Section 21C(f) of the Exchange Act.

IV.

IT IS ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened not earlier than 30 days and not later than 60 days from service of this Order at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice, 17 C.F.R. § 201.110.

IT IS FURTHER ORDERED that Respondent shall file an Answer to the allegations contained in this Order within twenty (20) days after service of this Order, as provided by Rule 220 of the Commission's Rules of Practice, 17 C.F.R. § 201.220.

If Respondent fails to file the directed answer, or fails to appear at a hearing after being duly notified, the Respondent may be deemed in default and the proceedings may be determined against him upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f) and 310 of the Commission's Rules of Practice, 17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f) and 201.310.

This Order shall be served forthwith upon Respondent personally or by certified mail.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 300 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice.

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64001 / March 2, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14280

In the Matter of **Advanced Optics Electronics, Inc.** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondent.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENT

Advanced Optics Electronics, Inc. ("ADOT") (CIK No. 1020657) is an inactive Nevada corporation located in Albuquerque, New Mexico with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). ADOT is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2007, which reported a net loss of $1,013,086 for the prior three months. As of November 8, 2010, the common stock of ADOT was quoted on the Pink Sheets, had nine market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

B. DELINQUENT PERIODIC FILINGS

1. As discussed in more detail above, the Respondent is delinquent in its periodic filings with the Commission, has repeatedly failed to meet its obligations to file timely periodic reports, and failed to heed delinquency letters sent to it by the Division of Corporation Finance requesting compliance with its periodic filing obligations or, through its failure to maintain a valid address on file with the Commission as required by Commission rules, did not receive such letters.

2. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers of securities registered pursuant to Exchange Act Section 12 to file with the Commission current and accurate information in periodic reports, even if the registration is voluntary under Section 12(g). Specifically, Rule 13a-1 requires issuers to file annual reports, and Rule 13a-13 requires issuers to file quarterly reports.

3. As a result of the foregoing, Respondent failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate for the protection of investors that public administrative proceedings be instituted to determine:

A. Whether the allegations contained in Section II hereof are true and, in connection therewith, to afford the Respondent an opportunity to establish any defenses to such allegations; and,

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or revoke the registration of each class of securities registered pursuant to Section 12 of the Exchange Act of the Respondent identified in Section II hereof, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of the Respondent.

IV.

IT IS HEREBY ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice [17 C.F.R. § 201.110].

IT IS HEREBY FURTHER ORDERED that Respondent shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220(b) of the Commission's Rules of Practice [17 C.F.R. § 201.220(b)].

If Respondent fails to file the directed Answers, or fails to appear at a hearing after being duly notified, the Respondent, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of the Respondent, may be deemed in default and the proceedings may be determined against it upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondent personally or by certified, registered, or Express Mail, or by other means permitted by the Commission Rules of Practice.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 120 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice [17 C.F.R. § 201.360(a)(2)].

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
March 2, 2011

In the Matter of **Advanced Optics Electronics, Inc.** **File No. 500 -1**	**ORDER OF SUSPENSION OF TRADING**

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Advanced Optics Electronics, Inc. because it has not filed any periodic reports since the period ended March 31, 2007.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in Advanced Optics Electronics, Inc. Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed company is suspended for the period from 9:30 a.m. EST on March 2, 2011, through 11:59 p.m. EDT on March 15, 2011.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64015 / March 2, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14087

In the Matter of Andain, Inc., Aquest Minerals Corp. (n/k/a Anderson Energy Ltd.), Ariel Resources, Ltd., Asensia, Inc., ATG, Inc., Audre Recognition Systems, Inc. (a/k/a eXtr@ct, Inc.) Axis.Com, Inc., and Aztek Technologies, Inc. (n/k/a Aztek Resource Development, Inc.), Respondents.	ORDER DISMISSING PROCEEDINGS WITH PREJUDICE AS TO ANDAIN, INC.

For good cause shown,

IT IS HEREBY ORDERED THAT this proceeding is hereby DISMISSED as to Respondent Andain, Inc. with prejudice.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64016 / March 2, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14281

In the Matter of

Andain, Inc.,

Respondent.

ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that public cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Andain, Inc. ("Andain" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement ("Offer"), which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which Respondent admits, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. Andain (CIK No. 1321502) is a revoked Nevada corporation located in Reno, Nevada. At all times relevant to this proceeding, the securities of Andain have been registered with the Commission under Exchange Act Section 12(g).

2. Andain has violated Exchange Act Section 13(a), and Rules 13a-1 and 13a-13 thereunder, because it has not filed any periodic reports since the period ended September 30, 2006.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanction agreed to in Andain's Offer.

Accordingly, it is hereby ORDERED that:

Pursuant to Section 21C of the Exchange Act, Andain cease and desist from committing or causing any violations and any future violations of Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 239, 270, and 274

[Release Nos. 33-9193; IC-29592; File No. S7-7-11]

RIN 3235-AL02

REFERENCES TO CREDIT RATINGS IN CERTAIN INVESTMENT COMPANY ACT RULES AND FORMS

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: This is one of several releases that the Securities and Exchange Commission ("Commission") will be considering relating to the use of credit ratings in our rules and forms. In this release, we are proposing a new rule as well as rule and form amendments under the Securities Act of 1933 and the Investment Company Act of 1940 to implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). The Commission is proposing amendments to two rules and four forms under the Investment Company Act and the Securities Act that contain references to credit ratings. The proposed amendments would give effect to provisions of the Dodd-Frank Act that call for the amendment of Commission regulations that contain credit rating references. In addition, the Commission is proposing a new rule under the Investment Company Act to establish a standard of credit-worthiness in place of a statutory reference to credit ratings in that Act that the Dodd-Frank Act removes.

DATES: Comments should be received on or before April 25, 2011.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml); or

- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-7-11 on the subject line; or
- Use the Federal eRulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-7-11. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's website (http://www.sec.gov/rules/proposed.shtml). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available.

FOR FURTHER INFORMATION CONTACT: With respect to the proposed rule, rule amendments or Form N-MFP, Anu Dubey, Attorney, or Penelope Saltzman, Assistant Director (202) 551-6792, Office of Regulatory Policy, or with respect to Forms N-1A, N-2 and N-3, Jane H. Kim, Attorney, or Mark T. Uyeda, Assistant Director, (202) 551-6784, Office of Disclosure Regulation, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-8549.

SUPPLEMENTARY INFORMATION: The Commission is proposing for public comment amendments to rules 2a-7 [17 CFR 270.2a-7] and 5b-3 [17 CFR 270.5b-3] and new rule 6a-5 [17 CFR 270.6a-5] under the Investment Company Act of 1940 ("Investment Company Act").[1] The Commission is also proposing for comment amendments to Forms N-1A [17 CFR 239.15A and 17 CFR 274.11A], N-2 [17 CFR 239.14 and 17 CFR 274.11a-1] and N-3 [17 CFR 239.17a and 17 CFR 274.11b] under the Investment Company Act and the Securities Act of 1933 ("Securities Act")[2] and Form N-MFP [17 CFR 274.201] under the Investment Company Act.

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1 15 U.S.C. 80a-1. Unless otherwise noted, all references to statutory sections are to the Investment Company Act, and all references to rules under the Investment Company Act are to Title 17, Part 270 of the Code of Federal Regulations [17 CFR 270].

2 15 U.S.C. 77a.

I. BACKGROUND

The Dodd-Frank Act was enacted on July 21, 2010.[3] Section 939A of the Act requires the Commission to review its regulations for any references to or requirements regarding credit ratings that require the use of an assessment of the credit-worthiness of a security or money market instrument, remove these references or requirements and substitute in those regulations other standards of credit-worthiness in place of the credit ratings that we determine to be appropriate.[4] Section 939 of the Dodd-Frank Act removes a reference to credit ratings from section 6(a)(5) of the Investment Company Act and replaces it with a reference to "such standards of credit-worthiness as the Commission shall adopt."[5]

In 2008, we undertook a review similar to that required under section 939A for references to credit ratings in our rules. As a result of that review, we proposed to eliminate references to ratings issued by nationally recognized statistical rating organizations ("NRSROs") in four rules under the Investment Company Act.[6] Specifically, we proposed to remove references to credit ratings in rules 2a-7, 3a-7, 5b-3 and 10f-3 under the Investment Company Act. In 2009, we

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3 Pub. L. No. 111-203, 124 Stat. 1376 (2010).

4 Section 939A(a)-(b) of the Dodd-Frank Act.

5 Section 939(c) of the Dodd-Frank Act (amending section 6(a)(5)(A)(iv)(I) of the Investment Company Act). The Dodd-Frank Act also requires the Commission to adopt a number of rules concerning the integrity and transparency of the credit rating process and the accountability of credit rating agencies. *See* sections 931 to 939H of the Dodd-Frank Act.

6 *See* References to Ratings of Nationally Recognized Statistical Rating Organizations, Investment Company Act Release No. 28327 (July 1, 2008) [73 FR 40124 (July 11, 2008)] ("2008 Ratings Removal Proposing Release"). The Commission also proposed to eliminate references to credit ratings in rules under the Securities Act and the Securities Exchange Act of 1934 (15 U.S.C. 78a) ("Exchange Act"). *See* Security Ratings, Securities Act Release No. 8940 (July 1, 2008) [73 FR 40106 (July 11, 2008)]; References to Ratings of Nationally Recognized Statistical Rating Organizations, Securities Exchange Act Release No. 58070 (July 1, 2008) [73 FR 40088 (July 11, 2008)]. Prior to this initiative, in 2003, the Commission published a concept release in which we sought comment on the use of NRSRO ratings in our rules. *See* Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws, Investment Company Act Release No. 26066 (June 4, 2003) [68 FR 35258 (June 12, 2003)].

adopted certain of the proposed amendments to rules 5b-3 and 10f-3 and reopened the comment period for the other proposed amendments to rules 3a-7 and 5b-3.[7] In 2010, when we adopted amendments to rule 2a-7 (which governs the operation of money market funds), we retained the use of credit ratings in rule 2a-7 as an initial threshold requirement for whether a money market fund may invest in the security, but eliminated a requirement that all asset-backed securities in which a money market fund invests have received a rating.[8]

As directed by section 939A of the Dodd-Frank Act, we have reviewed our regulations for any references to or requirements regarding credit ratings in regulations that require the use of an assessment of the credit-worthiness of a security or money market instrument. In light of our review, and as further directed by the Dodd-Frank Act, we are proposing in this release to amend two rules and four forms under the Investment Company Act and the Securities Act.[9] In addition, in order to implement section 939(c) of the Dodd-Frank Act, we are proposing a new

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7 *See* References to Ratings of Nationally Recognized Statistical Rating Organizations, Investment Company Act Release No. 28939 (Oct. 5, 2009) [74 FR 52358 (Oct. 9, 2009)] ("2009 Ratings Removal Adopting Release") (adopting amendments to rule 5b-3, with respect to the treatment of refunded securities, and rule 10f-3); References to Ratings of Nationally Recognized Statistical Rating Organizations, Investment Company Act Release No. 28940 (Oct. 5, 2009) [74 FR 52374 (Oct. 9, 2009)] at Section IV (reopening the comment period for the proposed amendments to rules 3a-7 and 5b-3, with respect only to repurchase agreements). We also sought comment on removing references to credit ratings in rule 2a-7 in our 2009 proposal for certain reforms for money market funds. *See* Money Market Fund Reform Proposing Release, *infra* note 8. We received over 70 comments in response to the 2008 proposed amendments. Most commenters opposed the proposals. These comment letters are available on the Commission's internet website (http://www.sec.gov/comments/s7-19-08/s71908.shtml; http://www.sec.gov/comments/s7-17-08/s71708.shtml). In light of today's proposal to amend rule 5b-3, we are withdrawing the 2008 proposed amendments to rule 5b-3 from further consideration.

8 *See* Money Market Fund Reform, Investment Company Act Release No. 29132 (Feb. 23, 2010) [75 FR 10060 (Mar. 4, 2010)] ("Money Market Fund Reform Adopting Release"). *See also* Money Market Fund Reform, Investment Company Act Release No. 28807 (June 30, 2009) [74 FR 32688 (July 8, 2009)] ("Money Market Fund Reform Proposing Release"). Most commenters that responded to our request for additional comment on the 2008 proposed amendments to rule 2a-7 in the Money Market Fund Reform Proposing Release opposed that approach.

9 We have already proposed to remove references to credit ratings in certain rules and forms under the Securities Act and the Exchange Act. *See* Security Ratings, Securities Act Release No. 9186 (Feb. 9, 2011) [76 FR 8946 (Feb. 16, 2011)].

rule to establish a standard of credit-worthiness for purposes of section 6(a)(5) of the Investment Company Act.

II. Discussion

Three rules -- rules 2a-7, 3a-7 and 5b-3 and four forms -- Forms N-1A, N-2, N-3 and N-MFP under the Investment Company Act currently contain references to credit ratings issued by NRSROs.[10] We propose to remove the references to credit ratings in rules 2a-7 and 5b-3 and replace them with alternative standards of credit-worthiness that are designed to appropriately achieve the same purposes as the ratings requirements. In addition to the amendments to rules 2a-7 and 5b-3, we are proposing a new rule – rule 6a-5 under the Investment Company Act – to establish a credit-worthiness standard to replace the credit rating reference in section 6(a)(5) of that Act that the Dodd-Frank Act eliminates.[11] Finally, we propose to eliminate required disclosures of credit ratings in Form N-MFP and remove from Forms N-1A, N-2 and N-3 the requirement that NRSRO credit ratings be used when portraying credit quality in shareholder reports. We discuss our proposed amendments and new rule in greater detail below.

A. Rule 2a-7

Rule 2a-7 under the Investment Company Act governs the operation of money market funds. Unlike other investment companies ("funds"), money market funds seek to maintain a stable share price, typically at $1.00 per share. To do so, most money market funds use the amortized cost method of valuation ("amortized cost method") and the penny-rounding method of pricing ("penny-rounding method") permitted by rule 2a-7.[12] The Investment Company Act

10 Rule 2a-7 defines the term NRSRO to have the same meaning as in section 3(a)(62) of the Exchange Act [15 U.S.C. 78c(a)(62)]. Rule 5b-3 defines NRSRO with reference to Exchange Act rule 15c3-1(c)(2)(vi)(E), (F), and (H) [17 CFR 240.15c3-1(c)(2)(vi)(E), (F), (H)].

11 We intend to propose amendments to rule 3a-7 in a separate release.

12 Under the amortized cost method, portfolio instruments are valued by reference to their

and applicable rules generally require funds to calculate current net asset value per share by valuing their portfolio instruments at market value or, if market quotations are not readily available, at fair value as determined in good faith by the board of directors.[13] These valuation requirements are designed to prevent unfair share pricing from diluting or otherwise adversely affecting the interests of investors.[14]

Rule 2a-7 exempts money market funds from these provisions but contains conditions designed to minimize the amount of risk a money market fund may assume and thus reduce the deviation between a money market fund's stabilized share price and the market value of its portfolio.[15] Among these conditions, rule 2a-7 limits a money market fund's portfolio investments to securities that have received credit ratings from the "requisite NRSROs" in one of the two highest short-term rating categories or comparable unrated securities (*i.e.*, "eligible

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acquisition cost as adjusted for amortization of premium or accretion of discount. *See* rule 2a-7(a)(2). Share price is determined under the penny-rounding method by valuing securities at market value, fair value or amortized cost and rounding the per share net asset value to the nearest cent on a share value of a dollar, as opposed to the nearest one tenth of one cent as otherwise would be required. *See* Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies (Money Market Funds), Investment Company Act Release No. 13380 (July 11, 1983) [48 FR 32555 (July 18, 1983)] ("1983 Money Market Fund Adopting Release") at n.6 ("Release 9786 sets the amount of less than 1/10 of one cent on a share value of one dollar as the benchmark for materiality."); Valuation of Debt Instruments by Money Market Funds and Certain Other Open-End Investment Companies, Investment Company Act Release No. 9786 (May 31, 1977) [42 FR 28999 (June 7, 1977)] at text accompanying n.11; rule 2a-7(a)(20) (defining penny-rounding method).

13 *See* section 2(a)(41) of the Investment Company Act (defining value) and rules 2a-4 (defining current net asset value) and 22c-1 (generally requiring open-end funds to sell and redeem their shares at a price based on the funds' current net asset value as next computed after receipt of a redemption, purchase or sale order).

14 If shares are sold or redeemed based on a net asset value that turns out to have been either understated or overstated compared to the amount at which portfolio instruments could have been sold, then the interests of either existing shareholders or new investors will have been diluted. *See Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Sen. Comm. on Banking and Currency*, 76th Cong., 3d Sess. 136-138, 288-289 (1940).

15 Rule 2a-7 contains conditions that apply to each investment a money market fund proposes to make, as well as conditions that apply to a money market fund's entire portfolio.

securities").[16] A requisite NRSRO must be one of the NRSROs that a money market fund's board of directors has designated ("designated NRSRO") for use, and determines at least annually issues credit ratings that are sufficiently reliable for the fund to use, in determining the eligibility of portfolio securities.[17] Rule 2a-7 further restricts money market funds to securities that the fund's board of directors (or its delegate[18]) determines present minimal credit risks, and specifically requires that determination "be based on factors pertaining to credit quality in addition to any ratings assigned to such securities by an NRSRO."[19]

We are proposing to remove references to credit ratings in rule 2a-7, which would affect five elements of the rule: determination of whether a security is an eligible security; determination of whether a security is a first tier security; credit quality standards for securities with a conditional demand feature; requirements for monitoring securities for ratings downgrades and other credit events; and stress testing.[20] The proposed amendments to rule 2a-7, which are similar to those we proposed in 2008, are designed to offer protections comparable to those provided by the NRSRO ratings.[21]

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16 The term "eligible security" is currently defined in rule 2a-7(a)(12).

17 *See* rule 2a-7(a)(11) (defining "designated NRSRO"); 2a-7(a)(23) (defining "requisite NRSRO").

18 *See* rule 2a-7(e).

19 Rule 2a-7(c)(3)(i). Thus, under the current rule, where the security is rated, having the requisite NRSRO rating is a necessary but not sufficient condition for investing in the security and cannot be the sole factor considered in determining whether a security presents minimal credit risks. *See* Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 18005 (Feb. 20, 1991) [56 FR 8113 (Feb. 27, 1991)] ("1991 Money Market Fund Adopting Release") at text preceding n.18.

20 The proposed rule also would make conforming amendments to rule 2a-7's recordkeeping and reporting requirements. *See* proposed rule 2a-7(c)(11)(iii).

21 We previously adopted certain of the amendments that we proposed in 2008 as part of the 2010 money market fund reforms. *See* Money Market Fund Reform Adopting Release, *supra* note 8, at Sections II.C.2, II.G.2. Specifically, we expressly limited money market funds' investments in illiquid securities. *See* rule 2a-7(c)(5)(i). We also required money market funds to notify the Commission promptly when an affiliate has purchased certain securities, including a security that is no longer an eligible security, from the fund in reliance on rule 17a-9, which permits certain

1. Eligible Securities

Under the proposed amendments, a money market fund would continue to be limited to investing in securities that money market fund boards of directors (or their delegates) determine present minimal credit risks,[22] and each of which is either a "first tier security" or a "second tier security" under the rule.[23] Fund boards of directors (which typically rely on the fund's adviser) would still be able to consider quality determinations prepared by outside sources, including NRSRO ratings, that fund advisers conclude are credible and reliable, in making credit risk determinations. We would expect the fund advisers to understand the method for determining the rating and make an independent judgment of credit risks, and to consider an outside source's record with respect to evaluating the types of securities in which the fund invests.

We propose to eliminate the requirement that an eligible security be rated by an NRSRO or be of comparable quality while maintaining the two-step analysis currently required by rule 2a-7. Under the proposed amendments, a security would be a first tier security (regardless of the ratings it has received from any credit rating agency) if the fund's board (or its delegate) determines that the issuer (or in the case of a security subject to a guarantee, the guarantor)[24] has

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affiliated persons to purchase certain portfolio securities from a money market fund under certain conditions. *See* rule 2a-7(c)(7)(iii)(B). *See also* 2008 Ratings Removal Proposing Release, *supra* note 6, at Sections III.A.2, III.A.4.

22 *See* proposed rule 2a-7(a)(11).

23 The proposal would not change current rule 2a-7 limitations on money market fund investments in second tier securities, under which a money market fund cannot acquire second tier securities with remaining maturities greater than 45 days, generally must limit its investments in second tier securities to no more than three percent of fund assets, and limit investments in the second tier securities of any one issuer to one half of one percent of fund assets. Rule 2a-7(c)(3)(ii); 2a-7(c)(4)(i)(C).

24 *See* rule 2a-7(c)(3)(iii) (allowing the credit quality of a guarantee to substitute for the credit quality of the security subject to the guarantee); 2a-7(a)(17) (defining "guarantee" to mean "an unconditional obligation of a person other than the issuer of the security to undertake to pay, upon presentment by the holder of the guarantee (if required), the principal amount of the underlying security plus accrued interest when due or upon default, or, in the case of an unconditional demand feature, an obligation that entitles the holder to receive upon exercise the approximate

the "highest capacity to meet its short-term financial obligations."[25] A security would be a second tier security if it is an eligible security but is not a first tier security.[26] In addition, a security would be an eligible security only if the board of directors (or its delegate) determines that it presents minimal credit risks, which determination must be based on factors pertaining to credit quality and the issuer's ability to meet its short-term financial obligations.[27]

We have designed these amendments to retain a degree of risk limitation on money market funds similar to the current rule. The proposed amendments would continue to require that funds invest at least 97 percent of their total assets in the highest quality short-term debt securities.[28] Money market fund holdings of these first tier securities would have to satisfy a

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amortized cost of the underlying security or securities, plus accrued interest, if any.").

25 Proposed rule 2a-7(a)(13). As under the current rule, government securities and securities issued by a money market fund also would be first tier securities. Proposed rule 2a-7(a)(13); *see* rule 2a-7(a)(14).

Our proposed amendments would eliminate the defined terms "designated NRSRO," "rated security," "requisite NRSRO," and "unrated security" from the rule. As a result, under the proposal, fund boards would no longer be required to designate NRSROs and funds would not have to disclose designated NRSROs in their statements of additional information ("SAI"). *See* rule 2a-7(a)(11) (defining "designated NRSRO" as one of at least four NRSROs that, among other things, the fund's board has designated as an NRSRO whose credit ratings will be used by the fund to determine the eligibility of portfolio securities, the board determines at least annually issues credit ratings sufficiently reliable for such use, and the fund discloses in its SAI is a designated NRSRO, including any limitations on the fund's use of the designation). We note that after enactment of the Dodd-Frank Act, money market funds received Commission staff assurances that the staff would not recommend enforcement action if a money market fund board did not designate NRSROs and did not make related disclosures in its SAI before the Commission had completed its review of rule 2a-7 required by the Dodd-Frank Act and made any modifications to the rule. *See* Investment Company Institute, SEC No-Action Letter (Aug. 19, 2010).

26 *See* proposed rule 2a-7(a)(21). The specific language of this provision would not change (*compare* current rule 2a-7(a)(24)), but the definitions of "eligible security" and "first tier security" would change under the proposal.

27 Proposed rule 2a-7(a)(11). Currently, the requirement that the fund board (or its delegate) determine that a security presents minimal credit risks is contained in paragraph (c)(3)(i) of the rule. In connection with the amendments discussed above, we propose to restructure the rule to incorporate the minimal credit risk determination into the definition of "eligible security," currently in paragraph (a)(12) of the rule, but which would be renumbered as paragraph (a)(11).

28 *See* proposed rule 2a-7(a)(13) (defining first tier security); rule 2a-7(c)(3)(ii) (prohibiting money

standard similar to the credit quality standards that have been articulated by the credit ratings agencies.[29] An issuer of a first tier security that would satisfy our proposed standard should have an exceptionally strong ability to repay its short-term debt obligations and the lowest expectation of default.[30] The credit risk associated with a second tier security, which would continue to be limited to three percent of total fund assets,[31] would differ from that associated with first tier securities only to a small degree. Thus, the issuer of a second tier security that would satisfy our proposed standard should have a very strong ability to repay its short-term debt obligations, and a very low vulnerability to default.[32] Finally, we propose to eliminate the requirement that

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market funds from acquiring second tier securities if, as a result of the acquisition, second tier securities would comprise more than three percent of the fund's total assets).

29 *See, e.g.,* Standard & Poor's Ratings Definitions, Short-Term Issue Credit Ratings, www.standardandpoors.com/ratings/articles/en/us/?assetID=1245219848760 ("S&P Ratings Definitions") (a short-term obligation rated "A-1" is rated in the highest category, and the obligor's capacity to meet its financial commitment on the obligation is strong; obligations within the category designated with a plus sign (+) indicates that the obligor's capacity to meet its financial commitment on these obligations is extremely strong); Moody's Investors Service Rating Symbols and Definitions, http://v3.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004 ("Moody's Ratings Definitions") at 5-6 (issuers rated Prime-1 "have a superior ability to repay short-term debt obligations."); FitchRatings, International Issuer and Credit Rating Scales, www.fitchratings.com/creditdesk/ublic/ratings_definitions/index.cfm?rd_file=ltr ("Fitch Ratings Definitions") (stating that a rating of F1 is the highest short-term rating, indicating the "strongest intrinsic capacity for timely payment of financial commitments; may have an added '+' to denote any exceptionally strong credit feature.").

30 We note that all money market fund portfolio securities also must be eligible securities (*i.e.*, present minimal credit risks under the proposed amendments). *See* proposed rule 2a-7(a)(13). Thus, even if the issuer had the highest capacity to meet its short-term financial obligations, a security, such as a subordinated short-term security secured by assets that are not of high credit quality, likely would not present minimal credit risks to a money market fund's portfolio and therefore likely would not be an eligible security.

31 Rule 2a-7(c)(3)(ii).

32 Nothing in the proposed rule would prohibit a money market fund from relying on policies and procedures it has adopted to comply with the current rule as long as the board (or its delegate) concluded that the ratings specified in the policies and procedures establish similar standards to those proposed, and are credible and reliable for that use. A fund also would be able to revise its policies and procedures to change or eliminate the use of specific NRSRO ratings or to incorporate other third party evaluations of credit quality.

guarantors or guarantees of securities held by a money market fund be rated by an NRSRO.[33]

Our proposal would eliminate the objective standard provided by credit ratings in the definitions of eligible security and first tier security and instead require a subjective determination of both eligible securities and first tier securities. We request comment on this proposed approach.

- Would our proposed approach achieve the goal of retaining a degree of risk limitation on money market funds similar to the current rule?
- Are there alternatives to our proposed approach that would provide a more robust or objective evaluation of credit quality?
- Is there a better way to describe the characteristics of a first tier security?
- Should we instead simply limit money market funds to investing in securities solely based on a minimal credit risk determination, *i.e.*, establish a single test for determining whether a fund could invest in a security?
- Would such an approach allow money market funds to invest a large portion of their portfolios in what are currently second tier securities?

2. Securities with a Conditional Demand Feature

Under rule 2a-7, a security subject to a conditional demand feature[34] may be determined to be an eligible security or a first tier security if, among other conditions, (i) the conditional

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33 *See* rule 2a-7(a)(12)(iii)(A). We also propose to move the provision that conditions the eligibility of a demand feature or guarantee of the issuer, or another institution, on an undertaking promptly to notify the fund in the event of a substitution of a demand feature or guarantee, which is currently in paragraph (a)(12)(iii)(B), to paragraphs (c)(3)(iii) (permitting money market funds to substitute the credit quality of a guarantee for the credit quality of the security subject to the guarantee in determining whether a security is an eligible or first tier security) and (c)(3)(iv)(D) (conditions under which a security subject to a conditional demand feature may be determined to be an eligible security or first tier security).

34 A conditional demand feature is a demand feature that a fund may be precluded from exercising because of the occurrence of a condition. *See* rule 2a-7(a)(6) (defining "conditional demand

demand feature is an eligible security or a first tier security, and (ii) the underlying security (or its guarantee) has received either a short-term rating or a long-term rating, as the case may be, within the highest two categories from the requisite NRSROs or is a comparable unrated security.[35] We propose to remove the credit rating requirement from this provision of the rule and amend the provision to require that the fund's board (or its delegate) determine that the underlying security be of high quality and subject to very low credit risk.[36] The proposed standard is designed to retain a similar degree of risk limitation to that in the current rule. An issuer that is determined to have a very strong capacity to meet its financial commitments, a very low risk of default, and a capacity for payment of its financial commitments that is not significantly vulnerable to reasonably foreseeable events would satisfy the proposed definition.[37]

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feature" as a demand feature that is not an unconditional demand feature); 2a-7(a)(28) (defining "unconditional demand feature" as a demand feature that by its terms would be readily exercisable in the event of a default in payment of principal or interest on the underlying security). For purposes of rule 2a-7, a demand feature allows the security holder to receive, upon exercise, the approximate amortized cost of the security, plus accrued interest, if any. In addition, a demand feature must be exercisable either: (i) at any time on no more than 30 calendar days' notice; or (ii) at specified intervals not exceeding 397 calendar days and upon no more than 30 days' calendar notice. Rule 2a-7(a)(9)(i). If an asset-backed security is subject to a demand feature, the feature must permit the security holder unconditionally to receive principal and interest within 397 calendar days of making demand. Rule 2a-7(a)(9)(ii).

35 Rule 2a-7(c)(3)(iv).

36 Proposed rule 2a-7(c)(3)(iv)(C). The rule references both short-term and long-term ratings because most money market fund portfolio securities with demand features are long-term securities (that would not meet the portfolio maturity requirements of rule 2a-7 without the demand feature). Under current rule 2a-7, a money market fund must limit its investments in securities subject to a demand feature or guarantee of the same issuer that are second tier securities to 2.5% of the fund's total assets. Rule 2a-7(c)(4)(iii). If, as a result of a downgrade, a fund exceeds this limitation on such securities, the fund must reduce its investment in the securities to no more than 2.5% of total assets by exercising the demand feature at the next succeeding exercise date(s). Rule 2a-7(c)(7)(i)(C). In a conforming change, we propose to amend this provision to require the fund to reduce its investment in securities subject to a demand feature or guarantee of a single issuer that are second tier securities, if, as a result of a portfolio security that ceases to be a first tier security, the fund exceeds the 2.5% investment limit on such securities. Proposed rule 2a-7(c)(7)(i)(B).

37 These credit quality characteristics are similar to credit quality standards that have been articulated by credit rating agencies. *See, e.g.*, S&P Ratings Definitions, *supra* note 29

In making the credit quality determinations required under the proposed amendment, a fund board (or its delegate) would continue to be able to consider analyses provided by third parties, including ratings provided by ratings agencies, that it concludes are credible and reliable for such purposes.[38]

We request comment on the proposed credit quality standard for securities with a conditional demand feature.

- Does our proposed standard retain the same or similar degree of risk limitation as that under the current rule?
- Are there alternative standards that would provide a more robust or objective evaluation of credit quality?

3. Monitoring Minimal Credit Risks

Rule 2a-7 currently requires a money market fund board (or its delegate) promptly to reassess whether a security that has been downgraded by an NRSRO continues to present minimal credit risks, and take such action as it determines is in the best interests of the fund and its shareholders.[39] We propose to amend the rule to require that, in the event the money market

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(describing the capacity of an issuer of long-term obligations rated "AA" as "very strong"); Moody's Ratings Definitions, *supra* note 29 (describing Aa-rated long-term obligations as "judged to be of high quality and are subject to very low credit risk."); Fitch Ratings Definitions, *supra* note 29 (describing AA-rated long-term obligations as denoting expectations of very low default risk and indicating that the issuer's capacity for payment of financial commitments is very strong and "not significantly vulnerable to foreseeable events").

38 The proposed amendment would not prohibit a money market fund from relying on policies and procedures it has adopted to comply with the current rule regarding the credit quality of securities with conditional demand features as long as the board (or its delegate) concluded that the ratings specified in the policies and procedures establish similar standards to those proposed, and that the agencies providing ratings used in the policies and procedures are credible and reliable for that use. A fund also could revise its policies and procedures to change or eliminate the consideration of specific NRSRO ratings or to incorporate other third party evaluations of credit quality.

39 Rule 2a-7(c)(7)(i)(A). This current reassessment is not required, however, if the downgraded security is disposed of or matures within five business days of the specified event and in the case of events specified in rule 2a-7(c)(7)(i)(A)(*2*), the board is subsequently notified of the adviser's

fund's adviser (or any person to whom the board has delegated portfolio management responsibilities) becomes aware of any credible information about a portfolio security or an issuer of a portfolio security that suggests that the security is no longer a first tier security or a second tier security, as the case may be, the board or its delegate would have to reassess promptly whether the portfolio security continues to present minimal credit risks.[40] To satisfy the proposed standard, an investment adviser would be required to exercise reasonable diligence in keeping abreast of new information about a portfolio security that the adviser believes to be credible. We understand that most money market fund advisers currently exercise a similar degree of diligence in monitoring their portfolios in order to meet the rule 2a-7 requirement that portfolio investments be limited to securities that the board determines present minimal credit risks.

We request comment on the proposed amendments for monitoring minimal credit risks.

- Would our proposed approach to describing when reassessment of whether a portfolio security presents minimal credit risks is required achieve the objective of retaining a degree of risk limitation on money market funds similar to the current rule?

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actions. Rule 2a-7(c)(7)(i)(B).

40 Proposed rule 2a-7(c)(7)(i)(A). As under the current rule, the proposal would not require reassessment in certain circumstances. *See supra* note 39. Our proposed standard differs slightly from our proposal in 2008, which would have required the board's reassessment if the money market fund's investment adviser became aware of *any* information about a portfolio security or an issuer of a portfolio security that suggested that the security might not have continued to present minimal credit risks. *See* 2008 Ratings Removal Proposing Release, *supra* note 6, at Section III.A.3. We believe that requiring the relevant information to relate to whether the portfolio security may no longer be first or second tier (as compared with the standard proposed in 2008) is more similar to the current standard. In addition, as noted by several commenters on the standard proposed in 2008, without limiting the information to be monitored in any way, the standard could be interpreted to require monitoring of all information regarding portfolio securities, including unreliable sources or unsubstantiated market rumors. *See, e.g.*, Comment Letter of CFA Institute Centre for Financial Market Integrity (Mar. 26, 2009); Comment Letter of Charles Schwab & Co., Inc. (Sept. 5, 2008); Comment Letter of Federated Investors, Inc. (Sept. 5, 2008).

- Is there an alternative or more objective standard for determining when the board must reassess the credit risk of a security that would provide adequate investor protections?
- Are we correct in our understanding of current monitoring practices?

4. *Stress Testing*

Rule 2a-7 currently requires money market funds to adopt written procedures for stress testing their portfolios. Specifically they must test the fund's ability to maintain a stable net asset value per share based on certain hypothetical events, including a downgrade of portfolio securities.[41] We propose to replace this reference to ratings downgrades with a hypothetical event that is designed to have a similar impact on a money market fund's portfolio. Our proposal would require that money market funds stress test for an adverse change in the ability of a portfolio security issuer to meet its short-term financial obligations.[42] Under the proposed rule, funds could continue to test their portfolios by treating a downgrade as a credit event that might adversely affect the value or liquidity of the portfolio security (and affect the fund's ability to maintain a stable net asset value per share).

We request comment on our proposed amendment to the stress testing requirements.

- Does the standard we propose adequately address the same concerns that arise when a security is downgraded?
- Is the proposed standard too broad?
- Would the proposed standard provide adequate guidance to funds?
- Is there a narrower standard that we should specify?

B. Form N-MFP

As part of the money market fund reforms we adopted in 2010, money market funds must

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41 Rule 2a-7(c)(10)(v)(A).

42 Proposed rule 2a-7(c)(10)(v)(A).

provide to the Commission a monthly electronic filing of portfolio holdings information on Form N-MFP.[43] The information money market funds must disclose with respect to each portfolio security (and any guarantee, demand feature or other enhancement associated with the portfolio security) includes the name of each designated NRSRO for the portfolio security and the rating assigned to the security.[44] We propose to eliminate the items requiring disclosure of ratings information from the form. We also propose to amend Item 33 of Form N-MFP to remove the reference to a rating in this item so that funds would only disclose whether a portfolio security is first or second tier or no longer an eligible security.[45]

- We request comment on the proposed form amendments.

C. Rule 5b-3

Rule 5b-3 under the Investment Company Act permits a fund, subject to certain conditions, to treat a repurchase agreement as an acquisition of the securities collateralizing the repurchase agreement in determining whether the fund is in compliance with two provisions of the Investment Company Act that may affect a fund's ability to invest in repurchase agreements. In a typical investment company repurchase agreement, a fund enters into a contract with a broker, dealer or bank (the "counterparty" to the transaction) for the purchase of securities. The counterparty agrees to repurchase the securities at a specified future date, or on demand, for a

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43 *See* rule 30b1-7. *See also* Money Market Fund Reform Adopting Release, *supra* note 8, at n.301 and accompanying and preceding text.

44 *See* Items 34 (requiring disclosure of each designated NRSRO for a portfolio security and the credit rating given by the designated NRSRO for each portfolio security); 37b-c (requiring disclosure of each designated NRSRO and the credit rating given by the designated NRSRO for each portfolio security demand feature); 38b-c (requiring disclosure of each designated NRSRO and the credit rating given by the designated NRSRO for each portfolio security guarantee); 39c-d (requiring disclosure of each designated NRSRO and the credit rating given by the designated NRSRO for each portfolio security enhancement) of Form N-MFP.

45 *See* Item 33 of Form N-MFP (requiring money market funds to disclose whether a security is a "rated" first or second tier security, an unrated security, or no longer an eligible security).

price that is sufficient to return to the fund its original purchase price, plus an additional amount representing the return on the fund's investment.[46]

Section 12(d)(3) of the Investment Company Act generally prohibits a fund from acquiring an interest in a broker, dealer, or underwriter. Because a repurchase agreement may be considered to be the acquisition of an interest in the counterparty, section 12(d)(3) may limit a fund's ability to enter into repurchase agreements with many of the firms that act as repurchase agreement counterparties. Section 5(b)(1) of the Investment Company Act limits the amount that a fund that holds itself out as being a diversified investment company may invest in the securities of any one issuer (other than the U.S. Government). This provision may limit the number and principal amounts of repurchase agreements a diversified fund may enter into with any one counterparty.

Rule 5b-3 allows funds to treat the acquisition of a repurchase agreement as an acquisition of securities collateralizing the repurchase agreement for purposes of sections 5(b)(1) and 12(d)(3) of the Investment Company Act if the obligation of the seller to repurchase the securities from the fund is "collateralized fully."[47] A repurchase agreement is collateralized fully

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46 Repurchase agreements provide funds with a convenient means to invest excess cash on a secured basis, generally for short periods of time. Economically, a repurchase agreement functions as a loan from the fund to the counterparty, in which the securities purchased by the fund serve as collateral for the loan and are placed in the possession or under the control of the fund's custodian during the term of the agreement. *See* Treatment of Repurchase Agreements and Refunded Securities as an Acquisition of the Underlying Securities, Investment Company Act Release No. 25058 (July 5, 2001) [66 FR 36156 (July 11, 2001)] ("Rule 5b-3 Adopting Release"). Various issues arose during the market events of 2007 to 2009 that affected the market for repurchase agreements. In response, a task force of participants in the market for tri-party repurchase agreements was formed and issued a report setting forth its findings and recommendations for improvements. *See* Report of Task Force on Tri-Party Repo Infrastructure, (May 17, 2010) at http://www.ny.frb.org/prc/report_100517.pdf.

47 Rule 5b-3(a). The term "collateralized fully" is defined in rule 5b-3(c)(1). In general, a fund investing in a repurchase agreement looks to the value and liquidity of the securities collateralizing the repurchase agreement rather than the credit quality of the counterparty for satisfaction of the repurchase agreement. *See* Rule 5b-3 Adopting Release, *supra* note 46, at

if, among other things, the collateral for the repurchase agreement consists entirely of (i) cash items, (ii) government securities, (iii) securities that at the time the repurchase agreement is entered into are rated in the highest rating category by the "requisite NRSROs"[48] or (iv) unrated securities that are of a comparable quality to securities that are rated in the highest rating category by the requisite NRSROs, as determined by the fund's board of directors or its delegate.[49] In proposing rule 5b-3, the Commission explained that the highest rating category requirement in the definition of collateralized fully was designed to help ensure that the market value of the collateral would remain stable and that the fund could more readily liquidate the collateral quickly in the event of a default.[50]

We propose to eliminate the requirement that collateral other than cash or government securities be rated in the highest category by the requisite NRSROs or be of comparable quality. In place of this requirement, we propose to require that collateral other than cash or government securities consist of securities that the fund's board of directors (or its delegate) determines at the

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Section II.A.3. *But see* rule 2a-7(c)(4)(ii)(A) (requiring money market funds to evaluate the counterparty's credit-worthiness).

48 The term "requisite NRSROs" means any two NRSROs that have issued a rating with respect to a security or class of debt obligations of an issuer or, if only one NRSRO has issued a rating with respect to such security or class of debt obligations of an issuer at the time the investment company acquires the security, that NRSRO. Rule 5b-3(c)(6).

49 Rule 5b-3(c)(1)(iv). The term "unrated securities" means securities that have not received a rating from the requisite NRSROs. Rule 5b-3(c)(8). We note, however, that as a result of our recent money market fund reforms, money market funds seeking similar treatment with respect to the diversification requirements under rule 2a-7 are subject to stricter limitations. In order to qualify for such special treatment, a repurchase agreement is collateralized fully only if the collateral for the repurchase agreement consists entirely of cash or government securities. Rule 2a-7(a)(5). *See* Money Market Fund Reform Adopting Release, *supra* note 8, at Section II.D.

50 *See* Treatment of Repurchase Agreements and Refunded Securities as an Acquisition of the Underlying Securities, Investment Company Act Release No. 24050 (Sept. 23, 1999) [64 FR 52476 (Sept. 29, 1999)] ("Rule 5b-3 Proposing Release") at n.43 and accompanying text (noting that the high quality requirement is designed to limit a fund's exposure to the ability of the counterparty to maintain sufficient collateral, and that securities of lower quality may be subject to greater price fluctuation).

time the repurchase agreement is entered into are: (i) issued by an issuer that has the highest capacity to meet its financial obligations; and (ii) sufficiently liquid that they can be sold at approximately their carrying value in the ordinary course of business within seven calendar days.[51] For purposes of rule 5b-3, an issuer would be defined to include an issuer of an unconditional guarantee of the security.[52] Thus, a collateral security with an unconditional guarantee, the issuer of which meets the proposed credit quality test, would satisfy that element of the proposed standard.

We have designed the proposed amendments to retain a degree of credit quality similar to that under the current rule. An issuer of collateral securities that the board (or its delegate) determined has an exceptionally strong capacity to repay its short or long-term debt obligations, as appropriate, the lowest expectation of default, and a capacity for repayment of its financial commitments that is the least susceptible to adverse effects of changes in circumstances would satisfy the proposed standard.[53]

Our proposal also would require that at the time the repurchase agreement is entered into, collateral could be sold at approximately its carrying value in the ordinary course of business

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51 Proposed rule 5b-3(c)(1)(iv)(C). Under the proposal, the board would make credit quality determinations for all collateral securities that are not government securities, rather than just unrated securities. As in the current rule, the proposed rule would permit the board to delegate the credit quality and liquidity determination. The proposed amendment to rule 5b-3 would not affect a money market fund that seeks special treatment under the diversification provisions of rule 2a-7 because in order to obtain such treatment, a money market fund is limited to investing in repurchase agreements collateralized by cash items or government securities. *See supra* note 49. We are proposing to amend rule 2a-7(a)(5), which defines "collateralized fully," to conform the references in that provision to the proposed amendments to rule 5b-3.

The first element of this proposed standard reflects the same standard as that proposed for the definition of first tier security under rule 2a-7. *See* proposed rule 2a-7(a)(13).

52 Proposed rule 5b-3(c)(4) (defining "issuer" to mean "the issuer of a collateral security or the issuer of an unconditional obligation of a person other than the issuer of the collateral security to undertake to pay, upon presentment by the holder of the obligation (if required), the principal amount of the underlying collateral security plus accrued interest when due or upon default.").

53 *See supra* text accompanying note 30.

within seven calendar days.[54] We expect that securities that trade in a secondary market at the time of the acquisition of the repurchase agreement would satisfy this liquidity standard. We also understand that most securities that are currently used to collateralize repurchase agreements[55] generally trade in a secondary market.

We have designed the proposed amendments to be clear enough to permit a fund board or fund investment adviser to make a determination regarding credit quality and liquidity that would achieve the same objectives that the credit rating requirement was designed to achieve, *i.e.*, to limit collateral securities to those that are likely to retain a fairly stable market value and that, under ordinary circumstances, the fund would be able to liquidate quickly in the event of a counterparty default.[56] We believe that fund advisers have experience with or knowledge of the evaluation of securities and would be qualified to make the credit and liquidity determinations proposed under the rule.[57]

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54 The proposed liquidity standard is the same as that we use for rule 2a-7. *See, e.g.*, rule 2a-7(a)(19) (defining illiquid security to mean a security that cannot be sold or disposed of in the ordinary course of business within seven calendar days at approximately the value ascribed to it by the fund).

55 *See* Tri-Party Repo Infrastructure, Reform Task Force, Tri-Party Repo Margin Data, Summary Statistics for the U.S. Tri-Party Repo Market (as of Jan. 11, 2011), http://www.newyorkfed.org/tripartyrepo/margin_data.html (describing 98.7% of tri-party repurchase agreement collateral as composed of asset-backed securities, agency collateralized mortgage backed obligations ("CMOs"), agency debentures and strips, agency mortgage-backed securities, private label CMOs, corporate debt, equity securities, money market instruments and U.S. Treasury securities).

56 *See supra* note 50. A fund that acquires repurchase agreements would, under rule 38a-1, have to adopt and implement a written policy reasonably designed to comply with the conditions of rule 5b-3, including any credit quality and liquidity requirements we might adopt under the rule. *See* rule 38a-1(a) (requiring registered funds to adopt and implement written policies and procedures reasonably designed to prevent the fund's violation of federal securities laws).

57 We note that under the current rule, if collateral securities are unrated, fund boards of directors (or their delegates) must determine that the securities are of comparable quality to securities rated in the highest category by an NRSRO. Rule 5b-3(c)(iv)(D).

Under the proposal, the board could delegate day-to-day determinations regarding the quality and liquidity of collateral if it chooses, provided that the board retained sufficient oversight. In addition, although the rule would no longer require the collateral to be rated by an NRSRO, fund boards (or their delegates) would still be able to consider analysis provided by outside sources, including credit agency ratings, that they conclude are credible and reliable, for purposes of making these credit quality evaluations.[58]

We request comment on our proposed amendment to rule 5b-3.

- Would the proposed determinations sufficiently address our concerns that collateral securities be of high quality in order to limit a fund's exposure to counterparties' credit risks? If not, are there additional or alternative standards that do not use credit ratings that would better address our concerns?
- Should a fund board (or its delegate) be permitted to consider assessments issued by third parties, as we anticipate? What, if any, criteria or standards should be imposed on the use of such assessments? Would the use of third party assessments help fund boards (or their delegates) arrive at consistent determinations regarding the credit quality of collateral under the rule?

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58 We understand that credit quality standards for securities collateralizing repurchase agreements are typically contained in the agreements between funds and counterparties. We expect that those standards include a rating (for rated collateral securities) and any additional criteria a fund manager considers necessary to ensure that the credit quality of collateral securities meets the fund's requirements, or for unrated securities, a comparable credit quality standard. The proposed amendment would not prohibit fund boards (or their delegates) from relying on the credit quality standards in current repurchase agreements and policies and procedures adopted to comply with the current rule regarding the credit quality of collateral securities as long as they conclude that the ratings specified in the repurchase agreements and policies and procedures establish similar standards to those proposed, and that the agencies providing the ratings used in the policies and procedures are credible and reliable for that use. A fund could also revise its repurchase agreements and policies and procedures to change or eliminate the consideration of specific NRSRO ratings or to incorporate other third party evaluations of credit quality.

- We propose to allow the credit quality of an issuer of an unconditional guarantee to substitute for the credit quality of the issuer of a collateral security subject to the guarantee.[59] This is designed to preserve a fund's ability to use the same types of collateral securities as it currently uses to satisfy the conditions of rule 5b-3. Should we instead limit collateral to securities that alone satisfy the proposed credit quality standard regardless of whether the security is subject to an unconditional guarantee?
- Would the proposed standard adequately address our concern that a fund be able to readily liquidate collateral securities in the event of a counterparty default?
- As noted above, we expect that, in general, securities that trade in secondary markets and most securities that are used as collateral for repurchase agreements would meet the proposed liquidity requirement. Are there securities typically used for collateral that would not meet the proposed liquidity standard?
- We have noted before that high quality securities generally are more liquid than lower quality securities.[60] Would the proposed credit quality requirement alone be sufficient to address concerns regarding liquidity of the collateral?
- We acknowledge that securities that may be liquid at the time of acquisition of the repurchase agreement may be less liquid when the counterparty defaults.[61] Would a different standard of liquidity provide any greater protection? For example, if we required that collateral could be sold at carrying value almost immediately, would it be

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59 *See* proposed rule 5b-3(c)(1)(iv)(C)(4).

60 *See* Rule 5b-3 Proposing Release, *supra* note 50, at n.43.

61 We have noted before the difficulties of liquidating collateral in the case of a default by a large counterparty when many investors in repurchase agreements seek to liquidate similar collateral at the same time. *See* Money Market Fund Reform Proposing Release, *supra* note 8, at n.229 and accompanying and preceding text.

more likely to remain liquid if many holders of the security are trying to sell at the same time? Would such a standard limit collateral securities to U.S. Treasury securities as a practical matter?

- In light of the potential for decreased liquidity of collateral securities at the time of a counterparty default, should we limit the exemption to repurchase agreements that are collateralized only by cash or government securities?
- Would we better achieve the goals of rule 5b-3 if the rule provided that a fund could no longer rely on rule 5b-3 if, at any point after the time a fund enters into a repurchase agreement, the collateral no longer met the proposed liquidity standard?

D. Proposed Rule 6a-5

Business and industrial development companies ("BIDCOs") are companies that operate under state statute that provide direct investment and loan financing, as well as managerial assistance, to state and local enterprises.[62] Because they invest in securities, BIDCOs frequently meet the definition of "investment company" under the Investment Company Act.[63] In 1996, the Investment Company Act was amended to add section 6(a)(5) to exempt these companies from most provisions of the Act subject to certain conditions.[64] The statutory exemption was premised

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[62] *See* S. REP. NO. 103-166, at 11 (1993) ("1993 Senate Report").

[63] For purposes of the Investment Company Act, an "investment company" means any issuer that (A) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities; (B) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or (C) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of government securities and cash items) on an unconsolidated basis. 15 U.S.C. 80a-3(a)(1).

[64] 15 U.S.C. 80a-6(a)(5); Pub. L. No. 104-290 § 501, 110 Stat. 3416, 3444 (1996). Section 6(a)(5)(B) provides that section 9 and, to the extent necessary to enforce section 9, sections 38 through 51, apply to a BIDCO as though the company were a registered investment company. Among other conditions to reliance on the exemption in section 6(a)(5), a BIDCO may not issue

on states having a strong interest in overseeing the structure and operations of these companies, thus rendering regulation under the Investment Company Act largely duplicative and unnecessary.[65]

BIDCOs that seek to rely on the exemption in section 6(a)(5) are limited with respect to the types of securities issued by investment companies and companies exempt from the definition of investment company under section 3(c)(1) or 3(c)(7) of the Act ("private funds") that they may purchase. Specifically, section 6(a)(5)(A)(iv) limits these BIDCOs from purchasing securities issued by investment companies and private funds other than debt securities that are rated investment grade by at least one NRSRO and securities issued by registered open-end investment companies that invest at least 65 percent of their assets in investment grade securities or securities that the fund determines are comparable in quality.[66] This provision was intended to provide limited flexibility to invest capital not immediately needed for the company's long-term commitments.[67] Although the legislative history of the

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redeemable securities.

65 *See* 1993 Senate Report, *supra* note 62, at 19 (further stating that states are well positioned to monitor these companies and address the needs of resident investors). Prior to the addition of section 6(a)(5), the Commission had granted orders to exempt BIDCOs from regulation under the Act. *See, e.g.*, The Idaho Company, Investment Company Release Nos. 18926 (Sept. 3, 1992) (notice) and 18985 (Sept. 30, 1992) (order).

66 15 U.S.C. 80a-6(a)(5)(A), as in effect prior to July 21, 2012 (exempting any company that is not engaged in the business of issuing redeemable securities, the operations of which are subject to regulation by the State in which the company is organized under a statute governing entities that provide financial or managerial assistance to enterprises doing business, or proposing to do business in that state if, among other things, the company does not purchase any security issued by an investment company or by any company that would be an investment company except for the exclusions from the definition of the term "investment company" under sections 3(c)(1) or 3(c)(7), other than (I) any debt security that is rated investment grade by not less than 1 nationally recognized statistical rating organization; or (II) any security issued by a registered open-end fund that is required by its investment policies to invest not less than 65% of its total assets in securities described in subclause (I) or securities that are determined by such registered open-end fund to be comparable in quality to securities described in subclause (I)).

67 *See* 1993 Senate Report, *supra* note 62, at 20.

provision does not specifically explain why Congress restricted BIDCOs to acquiring "investment grade" debt of investment companies and private funds, it may have been designed to limit BIDCOs to investing in debt securities of sufficiently high credit quality that they are likely to maintain a fairly stable market value and that could be liquidated easily, as appropriate, for the BIDCO to support its investment and financing activities.

As described above, section 939(c) of the Dodd-Frank Act eliminates the credit rating reference in section 6(a)(5)(A)(iv) of the Investment Company Act. Instead of limiting BIDCOs to purchasing debt securities issued by investment companies and private funds that are rated "investment grade," the amendment requires such debt securities to meet "such standards of credit-worthiness as the Commission shall adopt."

We are proposing new rule 6a-5 to establish this standard of credit-worthiness. Proposed rule 6a-5 would deem a BIDCO to have met the requirements for credit-worthiness of certain debt securities under section 6(a)(5)(A)(iv)(I) if the board of directors or members of the company (or its delegate) determines that the debt security is (i) subject to no greater than moderate credit risk and (ii) sufficiently liquid that the security can be sold at or near its carrying value within a reasonably short period of time.[68] The proposed standard is designed to limit BIDCOs to purchasing debt securities issued by investment companies or private funds of

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68 Proposed rule 6a-5. The standard for credit-worthiness that we are proposing in rule 6a-5 is similar to the standard that we adopted in rule 10f-3 under the Investment Company Act. *See* 2009 Ratings Removal Adopting Release, *supra* note 7, at Section II.B.2; rule 10f-3(a)(3). This credit quality standard differs from those we propose for rules 2a-7 and 5b-3 because it reflects the different standard of credit quality associated with the ratings referenced in rule 10f-3 and section 6(a)(5)(A)(iv)(I) of the Act before the amendment of each provision. *Compare supra* notes 16, 48, and accompanying text *with supra* note 66 and accompanying text and rule 10f-3(a)(3), as in effect before November 12, 2009 (conditioning an exemption to permit an investment company that is affiliated with members of an underwriting syndicate to purchase securities from the syndicate if certain conditions are met, including if the securities are municipal securities, that have received an investment grade rating, or if the securities are less seasoned, one of the three highest ratings, from an NRSRO).

sufficiently high credit quality that they are likely to maintain a fairly stable market value and may be liquidated easily, as appropriate, for the BIDCO to support its investment and financing activities. The board of directors or members of a BIDCO (or its delegate) would have to make the determination at the time of acquisition.[69] As a result of the proposed rule, section 6(a)(5) of the Act would also limit a BIDCO's investments in registered open-end funds to those funds that invest at least 65 percent of their assets in debt securities that meet our proposed standard.[70]

Moderate credit risk would denote current low expectations of default risk, with an adequate capacity for payment of principal and interest.[71] Debt securities (or their issuers) subject to a moderate level of credit risk would demonstrate at least average credit-worthiness relative to other similar debt issues (or issuers of similar debt).[72] In making these determinations, a BIDCO's board of directors, members or managers would be able to consider credit quality reports prepared by outside sources, including NRSRO ratings, that they conclude are credible and reliable for this purpose.

We request comment on proposed rule 6a-5.

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69 Proposed rule 6a-5. From our review of the state statutes under which BIDCOs are formed and operate, we understand that BIDCOs must be organized as corporations with boards of directors or limited liability companies that are managed by members or managers. *See, e.g.*, MICH. COMP. LAWS § 301 (2010) (stating that a company other than a Michigan corporation or a limited liability company cannot apply for a license to be a BIDCO); MONT. CODE ANN. § 102 (2010) (defining a BIDCO as a corporation that is licensed under the act to provide financial and management assistance to businesses); ALASKA STAT. § 20 (2010) (stating that a license to operate a BIDCO will be issued to a corporation if certain conditions are met); TENN. CODE ANN. § 208 (2010) (stating that a person other than a Tennessee corporation cannot apply for a license to be a BIDCO).

70 Section 6(a)(5)(A)(iv)(II) (permitting a BIDCO to purchase any security issued by a registered open-end fund that is required by its investment policies to invest not less than 65% of its total assets in securities described in subclause (I) (*i.e.*, securities that meet the standards of credit-worthiness that the Commission adopts) or securities that are determined by such registered open-end fund to be comparable in quality to securities described in subclause (I)).

71 *See* 2009 Ratings Removal Adopting Release, *supra* note 7, at n.86.

72 *Id.*

- Does the standard we have proposed provide BIDCOs with flexibility to invest in certain debt securities that are likely to retain their value and that a BIDCO could sell quickly if necessary to support its investment and financing activities? If not, are there additional or alternative standards that do not use credit ratings that would be more appropriate to the statutory intent of section 6(a)(5)?
- Is our understanding that BIDCOs are organized as corporations with a board of directors or limited liability companies with members or managers correct? Are there BIDCOs that are formed as partnerships or other structures?
- Do BIDCO directors or members have sufficient experience with or knowledge of evaluating securities to allow them to make the determinations called for by proposed rule 6a-5 or to oversee decisions made by a delegate?

E. Forms N-1A, N-2 and N-3

We are proposing to amend Forms N-1A, N-2 and N-3 to remove the required use of credit ratings assigned by an NRSRO. Forms N-1A, N-2 and N-3, among other things, contain the requirements for shareholder reports of mutual funds, closed-end funds, and certain insurance company separate accounts that offer variable annuities.[73]

Currently, Forms N-1A, N-2 and N-3 each require shareholder reports to include a table, chart, or graph depicting portfolio holdings by reasonably identifiable categories (*e.g.*, type of security, industry sector, geographic region, credit quality or maturity).[74] The forms require the categories to be selected in a manner reasonably designed to depict clearly the types of

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73 Form N-1A is used by open-end management investment companies, commonly known as mutual funds. Form N-2 is used by closed-end management investment companies. Form N-3 is used by separate accounts, organized as management investment companies, that offer variable annuity contracts.

74 Item 27(d)(2) of Form N-1A; Instruction 6(a) to Item 24 of Form N-2; Instruction 6(i) to Item 28(a) of Form N-3.

investments made by the fund, given its investment objectives. If credit quality is used to present portfolio holdings, the forms require that credit quality be depicted using the credit ratings assigned by a single NRSRO.

We are proposing to amend Forms N-1A, N-2 and N-3 to eliminate the required use of NRSRO credit ratings by funds that choose to use credit quality categorizations in the required table, chart or graph of portfolio holdings. If a fund chooses to use NRSRO credit ratings to depict credit quality of portfolio holdings, the proposal, like the current forms, generally would require the fund to use the credit ratings of a single NRSRO. This requirement is intended to eliminate the possibility that a fund could choose to use NRSRO credit ratings and then select the most favorable ratings among credit ratings assigned by multiple NRSROs. The proposal would clarify that, if credit ratings of the NRSRO selected by a fund are not available for certain holdings, the fund must briefly discuss the methodology for determining credit quality for those holdings, including, if applicable, the use of credit ratings assigned by another NRSRO.[75] Funds typically provide this discussion in their shareholder reports today.[76]

We request comment on the proposal to eliminate the required use of NRSRO credit ratings by funds that choose to use credit quality categorizations in shareholder reports.

- Are there better methods than the proposal by which funds could portray credit quality for purposes of the required table, chart or graph that presents portfolio holdings?

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75 Proposed Item 27(d)(2) of Form N-1A; proposed Instruction 6(a) to Item 24 of Form N-2; proposed Instruction 6(i) to Item 28(a) of Form N-3. In these items, we are also proposing to define NRSRO by reference to the Exchange Act definition, rather than by reference to Exchange Act rule 15c3-1 as is currently the case, and to replace the use of the term "rating" with "credit rating" as defined under the Exchange Act. *See* sections 3(a)(60) [15 U.S.C. 78c(a)(60)] and 3(a)(62) [15 U.S.C. 78c(a)(62)] of the Exchange Act, which define "credit rating" and "nationally recognized statistical rating organization," respectively.

76 This statement is based on a staff review of a sample of fund shareholder reports filed with the Commission.

- Does the proposal adequately address situations where a fund would choose to portray credit quality using NRSRO ratings and there is no single NRSRO that has rated all of the fund's portfolio holdings?

III. Request for Comment

We request comment on the rule and form amendments and new rule proposed in this release. We also request suggestions for additional changes to existing rules, and comments on other matters that might have an effect on the proposals contained in this release. Commenters are requested to provide empirical data to support their views.

IV. Paperwork Reduction Act

Certain provisions of our proposal contain "collections of information" within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[77] The titles for the existing collections of information are: (1) "Rule 2a-7 under the Investment Company Act of 1940, Money market funds"; (2) "Rule 30e-1 under the Investment Company Act of 1940, Reports to Stockholders of Management Companies";[78] (3) "Rule 38a-1 under the Investment Company Act of 1940, Compliance procedures and practices of registered investment companies"; and (4) "Form N-MFP under the Investment Company Act of 1940, Portfolio Holdings of Money Market Funds." We adopted the rules and form pursuant to the Investment Company Act. The Commission is submitting these collections of information to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11.

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77 44 U.S.C. 3501-3520.

78 The proposed amendments to Forms N-1A, N-2 and N-3 relate solely to the contents of fund shareholder reports. The PRA burden associated with fund shareholder reports is included in the burden associated with the collection of information for rule 30e-1 under the Investment Company Act rather than Forms N-1A, N-2 and N-3.

There is currently no approved collection of information for rule 5b-3 and the proposed amendments would not create any new collections under that rule. The proposed amendments to rule 5b-3 would, however, affect the collection of information burden for rule 38a-1. Proposed rule 6a-5 also would not create any new collections of information.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. The approved collection of information associated with rule 2a-7 displays control number 3235-0268. The approved collection of information associated with rule 30e-1 displays control number 3235-0025. The approved collection of information associated with rule 38a-1, which would be revised by the proposed amendments to rule 5b-3, displays control number 3235-0586. The approved collection of information associated with Form N-MFP displays control number 3235-0657.

A. Money Market Funds

1. Rule 2a-7

As discussed above, we are proposing to remove references to credit ratings in rule 2a-7, which would affect five elements of the rule. First, we propose to eliminate the requirement that an eligible security be rated by an NRSRO or be of comparable quality, while maintaining the two-step analysis currently required by rule 2a-7. A security would be an eligible security only if the board of directors (or its delegate) determines that it presents minimal credit risks, which determination must be based on factors pertaining to credit quality and the issuer's ability to meet its short-term financial obligations.[79] Second, we propose to define first tier security as a security whose issuer the fund's board (or its delegate) determines has the "highest capacity to

[79] Proposed rule 2a-7(a)(11). *See supra* Section II.A.1.

meet its short-term financial obligations."[80] Third, we propose to require that with respect to a security (or its guarantee) subject to a conditional demand feature, in addition to other conditions, the underlying security (or its guarantee) must itself be of high quality and subject to very low credit risk as determined by the fund's board (or its delegate).[81] Fourth, we propose to eliminate the use of credit ratings in the rule's downgrade and default provisions. The proposed amendment would require that in the event the money market fund's investment adviser (or any person to whom the fund's board of directors has delegated portfolio management responsibilities) becomes aware of any credible information about a portfolio security or an issuer of a portfolio security that suggests that the security is no longer a first tier security or a second tier security, as the case may be, the money market fund's board of directors would have to reassess promptly whether the portfolio security continues to present minimal credit risks.[82] Finally, we propose to eliminate the reference to portfolio securities' downgrades in the stress testing provisions. Under the proposal, a money market fund's stress testing procedures would be required to include as a hypothetical event, "an adverse change in the ability of the issuer of a portfolio security to meet its short-term financial obligations."[83] The respondents to these

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80 Proposed rule 2a-7(a)(13). *See supra* Section II.A.1.

81 Proposed rule 2a-7(c)(3)(iv)(C). *See supra* Section II.A.2.

82 Proposed rule 2a-7(c)(7)(i)(A). *See supra* Section II.A.3.

83 Proposed rule 2a-7(c)(10)(v)(A). *See supra* Section II.A.4. As a result of eliminating the term "designated NRSRO," the proposal would eliminate the requirement that boards of directors designate NRSROs and disclose such designated NRSROs in their SAIs. *See supra* note 25. We believe that the deletion of the disclosure requirement would not affect the collection of information requirements in the SAI, however, and therefore would not change current paperwork burden estimates. When we adopted the requirement to disclose designated NRSROs in the SAI, we stated that we anticipated that making this disclosure would not result in additional hourly burdens or printing costs beyond those currently approved in the existing collection of information for Form N-1A. *See* Money Market Fund Reform Adopting Release, *supra* note 8, at 106. The proposed amendments also would make conforming amendments to rule 2a-7's recordkeeping and reporting requirements. *See* proposed rule 2a-7(c)(11)(iii). These conforming changes would not result in changes in the estimated hourly burden associated with the

collections of information are money market funds. A fund must comply with the requirements of rule 2a-7, including the collections of information, in order to obtain the exemptive relief provided under the rule and to operate as a money market fund.

We do not anticipate that the proposed amendments would significantly change collection of information requirements under rule 2a-7 because we believe funds would likely rely on their current policies and procedures to comply with the proposed amendments. Under current rule 2a-7, money market fund boards, or their delegates, are required to perform a minimal credit risk evaluation with respect to each of the fund's portfolio securities. Funds also must adopt policies and procedures regarding those determinations.[84] Eligible securities and first tier securities currently are defined with reference to credit ratings, and securities subject to a conditional demand feature must meet a minimum credit rating threshold or if unrated, be of comparable quality. With respect to monitoring for downgrades and defaults, Commission staff understands that money market funds generally monitor for information regarding credit events that may affect the portfolio in addition to those specified in the rule. In addition, a fund could treat a downgrade as a credit event that might adversely affect a portfolio security. Finally, staff also understands that money market funds stress test for credit events other than downgrades that might affect the fund's portfolio. As we have noted above, with respect to each of the amendments we propose today, money market funds could continue to consider evaluations of outside sources, including credit ratings, in making credit quality determinations, monitoring and stress testing. Moreover, we anticipate that funds would likely continue to rely on their current policies and procedures with respect to credit quality determinations, monitoring for credit events and stress testing because that is likely to be less costly than revising policies.

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recordkeeping and reporting requirements.

84 *See* rules 2a-7(c)(3); 2a-7(c)(11)(ii); 2a-7(e); 38a-1.

Accordingly, we do not expect the proposed amendments would significantly change current collection of information burden estimates for rule 2a-7.[85] Nevertheless, money market funds may make technical changes to their policies and procedures in response to the proposed amendments, if adopted. Staff estimates that it would take, on average, 1.5 hours of a senior business analyst's time to make any technical changes for an individual money market fund, for an estimated one-time burden of 978 hours for all money market funds at a total cost of $226,896.[86] Amortized over three years, we estimate that the total annual burden would be 326 hours at a cost of $75,632.

- We request comment on these assumptions. If commenters believe these assumptions are not accurate, we request they provide specific data that would allow us to make more accurate estimates.

2. *Form N-MFP*

Rule 30b1-7 requires money market funds to file electronically a monthly report on Form N-MFP within five business days after the end of each month. The information required by the form must be data-tagged in XML format and filed through EDGAR. Preparing Form N-MFP is a collection of information under the PRA.[87] The respondents to the requirement to prepare

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85 The current approved annual burden for rule 2a-7 under the PRA is 395,779 hours. The estimated number of respondents is 652 money market funds as of December 31, 2010. The estimated number of money market funds is based on the Investment Company Institute, Trends in Mutual Fund Investing, December 2010 (Jan. 27, 2011), http://www.ici.org/research/stats/trends/trends_12_10.

86 These estimates are based on the following calculation: (652 money market funds x 1.5 hours = 978 hours); (978 hours x $232 per hour = $226,896). The staff estimates that the internal cost of a senior business analyst is $232 per hour. This estimate, as well as other internal time cost estimates made in this analysis, is derived from SIFMA's *Management and Professional Earnings in the Securities Industry* 2010, modified by Commission staff to account for an 1800-hour work week and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

87 For purposes of the PRA analysis, the current burden associated with the requirements of rule 30b1-7 is included in the collection of information requirements of Form N-MFP. The current

Form N-MFP are investment companies that are regulated as money market funds under rule 2a-7. Compliance with the requirement to prepare Form N-MFP is mandatory for any fund that holds itself out as a money market fund in reliance on rule 2a-7. Responses to the disclosure requirement of Form N-MFP are not kept confidential.

As discussed previously, the proposed amendments would eliminate the items requiring disclosure for each portfolio security (and any guarantee, demand feature or enhancement associated with the portfolio security) of the designated NRSROs for the security and the rating assigned to the security in Items 34, 37, 38 and 39 of the Form. The proposed amendments would also eliminate the requirement in Item 33 that a money market fund disclose whether a security is a rated security or an unrated security.

The staff estimates that, as of December 31, 2010, there are approximately 652 money market funds that are required to file Form N-MFP.[88] The staff estimates that our proposed amendments would reduce the time it takes money market funds to complete Form N-MFP by 0.5 hours. Because Form N-MFP is completed 12 times a year, the staff estimates that each respondent would save approximately 6 hours annually (at an internal cost of $301 per hour).[89] The staff therefore estimates that our proposed amendments to Form N-MFP would result in total incremental time savings of approximately 3912 hours (and $1,177,512) annually.[90]

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approved annual burden for Form N-MFP under the PRA is 94,189 hours.

88 *See supra* note 85.

89 The staff estimates that the internal cost of a senior database administrator is $301 per hour.

90 These estimates are based on the following calculation: (652 x 6 hours = 3912 hours); (3912 hours x $301 per hour = $1,177,512). We understand that some money market funds may outsource all or a portion of their responsibilities regarding Form N-MFP to a filing agent, software consultant, or other third-party service provider. We believe that a fund would engage third-party service providers at an external cost similar to or less than the estimated internal costs so the amount of the savings would be comparable.

- We request comment on these estimates. If commenters believe these estimates are not accurate, we request they provide specific data that would allow us to make more accurate estimates.

B. Rule 5b-3

Rule 5b-3 under the Investment Company Act allows funds to treat the acquisition of a repurchase agreement as an acquisition of securities collateralizing the repurchase agreement for purposes of sections 5(b)(1) and 12(d)(3) of the Act under certain conditions. We propose to amend rule 5b-3 to require that the securities collateralizing a repurchase agreement consist of securities that the fund's board of directors, or its delegate, determines are issued (or have unconditional guarantees that are issued) by an issuer that has the highest capacity to meet its financial obligations and are highly liquid.[91] To that end, the fund's board of directors, pursuant to rule 38a-1 under the Act, would have to develop procedures to ensure that at the time the repurchase agreement is entered into, the securities meet the requirements for collateral outlined in the proposed amendments to the rule.[92] As discussed above, these procedures are designed to limit collateral securities to those that are likely to retain a stable market value and that, in ordinary circumstances, the fund would be able to liquidate quickly in the event of a default. This collection of information would be mandatory for funds that rely on rule 5b-3. Records of information made in connection with this requirement would be required to be maintained for inspection by Commission staff, but the collection would not otherwise be submitted to the

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91 Proposed rule 5b-3(c)(1)(iv)(C). *See supra* Section II.C.

92 Under rule 38a-1, funds must have written policies and procedures reasonably designed to prevent violation of the federal securities laws. Rule 38a-1(a)(1). Funds thus would have policies and procedures for complying with rule 5b-3, which would include policies and procedures relating to credit quality determinations of unrated collateral securities, if appropriate.

Commission. The information, when provided to the Commission in connection with staff examinations or investigations, would be kept confidential to the extent permitted by law.

We do not anticipate that the proposed amendments would significantly change collection of information burdens under rule 38a-1 because we believe funds would likely rely on their current policies and procedures to determine the credit quality of collateral securities to comply with rule 5b-3, as we propose to amend it. We understand that credit quality standards for securities collateralizing repurchase agreements are contained in the repurchase agreements between funds and counterparties. We expect that those standards currently include a rating and any additional criteria a fund manager considers necessary to ensure that the credit quality of the collateral securities meets the fund's requirements, or, for unrated securities, a comparable credit quality standard. Counterparties provide collateral securities to conform to these standards and funds confirm that the securities are conforming. As we have noted above, funds could continue to consider evaluations of outside sources, including credit ratings, that the board determines are credible and reliable in making their credit quality determinations under the proposed rule. We expect that funds would likely continue to rely on their current policies and procedures (*i.e.*, using credit quality standards that include ratings currently set forth in their repurchase agreements with counterparties). Thus, we do not expect that the proposed amendments would significantly change the current collection of information burden estimates for rule 38a-1.[93] Nevertheless, funds may review their repurchase agreements and policies and procedures that address rule 5b-3 compliance and make technical changes to those documents in response to the proposed amendments, if adopted. Staff estimates that it will take, on average, 1.5 hours of a senior business analyst's time to perform this review and make any technical changes for an

93 The current approved annual burden for rule 38a-1 under the PRA is 254,703 hours.

individual fund portfolio, for an estimated burden of 12,690 hours for all fund portfolios (other than money market fund portfolios)[94] at a total cost of $2,944,080.[95] Amortized over three years, we estimate that the total burden would be 4230 hours at a cost of $981,360. We anticipate that the fund's board would review the fund manager's recommendation, but that the cost of this review would be incorporated in the fund's overall annual board costs and would not result in any particular additional cost.

- We request comment on these estimates. If commenters believe these estimates are not accurate, we request they provide specific data that would allow us to make more accurate estimates.
- Is our expectation that funds would continue to consider ratings in their credit quality standards to evaluate rated collateral securities for repurchase agreements correct? If funds choose not to continue this consideration of ratings, we request comment on how long it would take a fund to confirm that collateral securities satisfy the credit quality standards in a repurchase agreement under our proposed standard.

C. Rule 30e-1

The proposed amendments to Forms N-1A, N-2 and N-3 eliminate the required use of NRSRO credit ratings by funds that choose to use credit quality categorizations in the required table, chart, or graph of portfolio holdings. If a fund chooses to use NRSRO credit ratings to depict credit quality of portfolio holdings, the proposed amendments, like the current forms,

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94 For purposes of this PRA analysis, we assume that all funds enter into repurchase agreements and rely on rule 5b-3. We have not included money market funds in our estimates, however, because they are subject to different requirements under rule 2a-7, as noted above. *See supra* note 49. The staff's estimate of the number of fund portfolios is based on staff examination of industry data as of December 31, 2010.

95 These estimates are based on the following calculation: (8460 fund portfolios x 1.5 hours = 12,690 hours); (12,690 hours x $232 per hour = $2,944,080). The staff estimates that the internal cost for time spent by a senior business analyst is $232 per hour.

generally would require the fund to use the credit ratings of a single NRSRO. The proposed amendments would clarify that, if credit ratings of the NRSRO selected by a fund are not available for certain holdings, the fund must briefly discuss the methodology for determining credit quality for those holdings, including, if applicable, the use of credit ratings assigned by another NRSRO.

The Commission believes that the proposed amendments to Forms N-1A, N-2 and N-3 would not affect the current PRA burden under rule 30e-1, because funds would remain obligated to provide a table, chart, or graph of portfolio holdings by reasonably identifiable categories. The proposed amendments only eliminate the required use of NRSRO credit ratings by funds that choose to use credit quality categorizations. The Commission further believes that the proposed clarification for cases when credit ratings of the NRSRO selected by a fund are not available for certain holdings would not impose any additional PRA burden because funds typically provide this disclosure in their shareholder reports today.[96]

- We request comment on this analysis. If commenters believe this analysis is not accurate, we request that they provide specific data that would allow us to make a more accurate analysis.

D. Request for Comments

We request comment on whether the estimates provided in this PRA analysis are accurate. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments in order to: (i) evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimate of the burden of the

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96 This assessment is based on a staff review of a sample of fund shareholder reports filed with the Commission.

proposed collections of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements of the proposed amendments should direct them to the Office of Management and Budget, Attention Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 10102, New Executive Office Building, Washington DC 20503, and should send a copy to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, with reference to File No. S7-7-11. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this Release; therefore a comment to OMB is best assured of having its full effect if OMB receives it within 30 days after publication of this Release. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-7-11, and be submitted to the Securities and Exchange Commission, Office of Investor Education and Advocacy, 100 F Street, NE, Washington, DC 20549-0213.

V. Cost-Benefit Analysis

The Commission is sensitive to the costs and benefits imposed by its rules. We have identified certain costs and benefits of the proposed rule and form amendments and proposed rule, and we request comment on all aspects of this cost-benefit analysis, including identification and assessment of any costs and benefits not discussed in this analysis. We seek comment and data on the value of the benefits identified. We also welcome comments on the accuracy of the cost estimates in each section of this analysis, and request that commenters provide data that may be relevant to these cost estimates. In addition, we seek estimates and views regarding these costs and benefits for particular funds, including funds that are small entities, as well as any other costs or benefits that may result from the adoption of the proposed rule and rule and form amendments. Where possible, we request commenters provide empirical data to support any positions advanced.

As discussed above, to implement provisions of the Dodd-Frank Act, we propose to (i) remove the references to credit ratings in rules 2a-7 and 5b-3 and replace them with alternative standards of credit-worthiness that are designed to appropriately achieve the same purposes as the ratings, (ii) eliminate references to credit ratings in Form N-MFP, and (iii) remove from Forms N-1A, N-2 and N-3 the requirement that NRSRO credit ratings be used when portraying credit quality in shareholder reports. We are also proposing rule 6a-5 to replace a statutory reference to credit ratings that the Dodd-Frank Act removes from the Investment Company Act and for which the Dodd-Frank Act anticipates the Commission will adopt a replacement standard. Thus, the benefits and costs associated with the replacement of credit rating references with alternative standards of credit-worthiness are attributable to the Dodd-Frank Act. The Commission has discretion, however, in adopting the alternative standards of credit-worthiness, and we undertake below to discuss the costs and benefits of the rule and form amendments and new rule that we are proposing.

A. Money Market Funds

1. Rule 2a-7

As discussed above, we are proposing to remove references to credit ratings in rule 2a-7, which would affect five elements of the rule. First, we propose to eliminate the requirement that an eligible security be rated by an NRSRO or be of comparable quality, while maintaining the two-step analysis currently required by rule 2a-7. A security would be an eligible security only if the board of directors (or its delegate) determines that it presents minimal credit risks, which determination must be based on factors pertaining to credit quality and the issuer's ability to meet its short-term financial obligations.[97] Second, we propose to define first tier security as a security whose issuer the fund's board (or its delegate) determines has the "highest capacity to meet its short-term financial obligations."[98] Third, we propose to require that with respect to a security (or its guarantee) subject to a conditional demand feature, in addition to other conditions, the underlying security (or its guarantee) must itself be of high quality and subject to very low credit risk as determined by the fund's board (or its delegate).[99] Fourth, we propose to remove the reference to credit ratings in the rule's downgrade and default provisions. The proposed amendment would require that, in the event the money market fund's investment adviser (or any person to whom the fund's board of directors has delegated portfolio management responsibilities) becomes aware of any credible information about a portfolio security or an issuer of a portfolio security that suggests that the security is no longer a first tier security or a second tier security, as the case may be, the money market fund's board of directors would have to reassess promptly whether the portfolio security continues to present minimal credit risks.[100] Finally, we propose to eliminate the reference to portfolio securities' downgrades in the stress testing provisions. Under the proposal, a money market fund's stress testing

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97 Proposed rule 2a-7(a)(11). *See supra* Section II.A.1.

98 Proposed rule 2a-7(a)(13). *See supra* Section II.A.1.

99 Proposed rule 2a-7(c)(3)(iv)(C). *See supra* Section II.A.2.

100 Proposed rule 2a-7(c)(7)(i)(A). *See supra* Section II.A.3.

procedures would be required to include as a hypothetical event, "an adverse change in the ability of the issuer of a portfolio security to meet its short-term financial obligations."[101]

a. Benefits

We believe that the proposed amendments to rule 2a-7 may provide certain benefits to money market funds. As discussed above, in connection with the PRA analysis, money market funds have adopted policies and procedures that with respect to portfolio securities (including securities subject to a conditional demand feature) address credit quality, minimal credit risk determinations, monitoring for downgrades and defaults and stress testing. Under the proposed rules, money market funds could revise their policies and procedures with respect to each of these requirements to change or eliminate the consideration of credit ratings or consider other sources of credit quality evaluations as funds determine would be appropriate. Nevertheless, because the proposed amendments are designed to retain the same degree of credit risk limitation and similar standards for monitoring credit events and stress testing as under current rule 2a-7, the proposed amendments would not prohibit a money market fund from using its current policies and procedures to comply with the proposed amendments. In particular, as discussed above, fund boards (or their delegates) could still consider credit quality evaluations prepared by outside sources, including NRSRO ratings, that they conclude are credible and reliable for purposes of making credit quality determinations with respect to portfolio securities (including securities subject to a conditional demand feature), monitoring minimal credit risks of the portfolio and stress testing. We expect that each money market fund would undertake its own

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101 Proposed rule 2a-7(c)(10)(v)(A). *See supra* Section II.A.4. As noted above, *see supra* note 20, the proposed amendments would make conforming changes to rule 2a-7's recordkeeping and reporting requirements. We do not believe that these amendments would affect costs.

analysis of the costs or benefits of revising policies and procedures and would only change them to the extent the fund believed the benefits justified the costs of doing so.

Although some money market funds may eliminate the specific use of ratings in their credit risk determinations, we anticipate that many of those funds are likely to consider some outside analyses in evaluating the credit quality of, and minimal credit risks presented by, portfolio securities (including securities subject to a conditional demand feature). Fund boards' (or their delegates') consideration of external analyses by third party sources determined to be credible and reliable to the extent the fund board (or its delegate) considers appropriate may contribute to the accuracy of funds' determinations and thus help money market funds arrive at consistent credit risk determinations.

b. Costs

We recognize that there may be minor costs associated with the proposed amendments to rule 2a-7. Money market funds may incur some costs internally or to consult outside legal counsel to evaluate any need to change their policies and procedures relating to determinations of credit quality, monitoring for credit events and stress testing if the proposed amendments were adopted. We do not believe, however, that these costs are attributable to the proposed rule and form amendments because the requirement in the Dodd-Frank Act that we replace the use of credit ratings in rules with alternative standards of credit-worthiness would result in similar costs of evaluating compliance with a new credit quality standard.

As discussed above, because the proposed amendments are designed to retain the same degree of credit risk limitation and similar standards for monitoring credit events and stress testing as under current rule 2a-7, a money market fund also could use its current policies and procedures to comply with the proposed amendments. In particular, as discussed above, a fund could still incorporate credit quality evaluations prepared by outside sources, including NRSRO ratings, that the fund's board or adviser concludes are credible and reliable for purposes of making credit quality determinations with respect to portfolio securities (including securities subject to a conditional demand feature), monitoring minimal credit risks of the portfolio, and stress testing. We expect that each money market fund would undertake its own analysis of the costs or benefits of revising policies and procedures and would only change its policies to the extent the fund believed the benefits justified the costs of doing so. Nevertheless, money market funds may make technical changes to their policies and procedures in response to the proposed amendments, if adopted. We estimate that money market funds would incur a one-time aggregate cost of $226,896 to make any technical changes.[102]

In addition to the costs that funds may incur, the removal of credit ratings pursuant to the Dodd-Frank Act may result in increased risks to money market funds and their shareholders. As discussed above, rule 2a-7 limits money market funds to investing in securities that, among other things, have received a rating in one of the highest two short-term rating categories from the requisite NRSROs or are unrated securities of comparable quality.[103] The rule further limits money market funds' investments in second tier securities to no more than three percent of the fund's portfolio.[104] The minimum credit rating requirement in the current rule provides the Commission with an objective standard to use in examining and enforcing money market fund compliance with rule 2a-7's credit quality conditions, including the limitation on investments in second tier securities. As discussed above, the proposed rule would eliminate the requirement that eligible securities meet minimum rating requirements, while maintaining the two-step

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102 *See supra* note 86 and accompanying text.

103 *See* rule 2a-7(a)(12)(i)-(ii); *supra* notes 15-17 and accompanying text.

104 Rule 2a-7(c)(3)(ii).

analysis provided in the current rule and the limitation on investments in second tier securities.[105] Although we anticipate that funds would continue to manage risk in the same manner as under the current rule, under the proposed subjective standard, a money market fund board (or its delegate) could disregard a second tier rating in order to invest a larger portion of the fund's portfolio in lower quality securities that it classifies as first tier securities. In addition, it could be difficult for the Commission to challenge the determination of a money market fund board (or its delegate) in those circumstances.[106]

2. Form N-MFP

We propose to amend Form N-MFP to eliminate the items requiring disclosure for each portfolio security (and any guarantee, demand feature or enhancement associated with the portfolio security) of the designated NRSROs for the security and the rating assigned to the security. We also propose to eliminate the requirement that a money market fund disclose whether a security is a rated security or an unrated security.

a. Benefits

The proposed amendments to Form N-MFP would conform the disclosure in Form N-MFP to the proposed amendments to rule 2a-7. The proposed amendments to Form N-MFP should reduce costs for money market funds by eliminating from the form certain disclosure items relating to designated NRSROs and ratings, which would no longer be elements of rule 2a-7. For purposes of the PRA analysis, we estimate that money market funds would realize, in

105 *See supra* note 23, notes 24-25 and accompanying and preceding text.

106 The increased risks to money market funds associated with investments in short-term securities rated second tier are discussed in detail in the Money Market Fund Reform Adopting Release, *supra* note 8, at Section II.A.1. and Money Market Fund Reform Proposing Release, *supra* note 8, at Section II.A.1.

the aggregate, a cost savings of $1,177,512 in completing Form N-MFP as a result of the proposed amendments.[107]

b. Costs

We do not believe there would be any costs associated with the proposed amendments to Form N-MFP.

B. Rule 5b-3

We propose to amend rule 5b-3 to allow a fund to treat the acquisition of a repurchase agreement as an acquisition of securities collateralizing the repurchase agreement for purposes of sections 5(b)(1) and 12(d)(3) of the Investment Company Act if the collateral other than cash or government securities consists of securities that the fund's board of directors, or its delegate, determines at the time the repurchase agreement is entered into are: (i) issued by an issuer that has the highest capacity to meet its financial obligations; and (ii) sufficiently liquid that they can be sold at approximately their carrying value in the ordinary course of business within seven days.

1. Benefits

We believe that the proposed amendments to rule 5b-3 may yield certain benefits. First, our proposed standard is designed to achieve the same purpose as the credit rating reference in the existing rule. *i.e.,* limit collateral securities to those that are likely to retain a stable market value and that, under ordinary circumstances, the fund would be able to liquidate quickly in the event of a counterparty default. Second, we believe that the proposed standards would not result in significant changes in fund evaluations of the quality of collateral securities. A fund's board of directors or its delegate is already required under the rule to assess the credit quality of

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107 *See supra* note 90 and accompanying text. As noted above, however, money market funds have not had to make these disclosures so actual savings may be less.

unrated securities.[108] As noted above, funds typically establish standards for the credit quality of collateral securities (that include credit ratings and additional credit quality criteria required by the fund) in repurchase agreements with counterparties.[109] In addition, although the rule would no longer require the collateral to be rated by an NRSRO, the evaluation of credit risk could incorporate ratings, reports, analyses and other assessments issued by third parties, including NRSRO ratings, that the board concludes are credible and reliable for purposes of making the evaluation. We expect that the ability to consider outside assessments would help minimize any burdens on the fund's board or its delegate under the proposed amendments. In addition, the use of external analyses by third party sources that fund boards (or their delegates) believe are credible and reliable to the extent the fund board (or its delegate) considers appropriate may contribute to the accuracy of funds' determinations and thus help funds arrive at consistent minimal credit risk determinations.

2. *Costs*

The proposed credit quality standard for rule 5b-3 may impose costs on funds that rely on the rule. A fund's board of directors, or its delegate, pursuant to rule 38a-1 of the Act, would be required to develop written policies or procedures to ensure that at the time the repurchase agreement is entered into, the collateral meets the requirements outlined in the proposed amendments.[110] Consistent with the requirements of rule 38a-1 under the Act, we expect that boards of funds relying on rule 5b-3 have established procedures regarding compliance with the rule. We recognize that these funds may incur minor costs associated with the proposed amendments to rule 5b-3 including some internal costs or costs of consulting outside legal

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108 Rule 5b-3(c)(1)(iv)(D).

109 *See supra* text preceding note 93.

110 Rule 38a-1(a).

counsel to determine whether they must change their policies and procedures for evaluating collateral securities if the proposed amendments are adopted. We do not believe, however, that those costs are attributable to the proposed amendments because the requirement in the Dodd-Frank Act that we replace the use of credit ratings in rules with alternative standards of credit-worthiness would result in similar costs of evaluating compliance with a new standard of credit quality.

As noted above, funds typically set forth credit quality standards for securities collateralizing a repurchase agreement in the agreement with the counterparty. We expect that those standards include a rating and any additional criteria a fund manager considers necessary to ensure that the credit quality of the collateral meets the fund's requirements. As we have noted above, fund boards (or their delegates) could continue to consider evaluations of outside sources, including credit rating agencies, in making their credit quality determinations under rule 5b-3, as we propose to amend it. We anticipate that funds would likely continue to rely on the credit quality standards in their current repurchase agreements and their existing policies and procedures that address compliance with rule 5b-3 if the proposed amendments were adopted. We expect that each fund would undertake its own analysis of the costs or benefits of revising repurchase agreements and policies and procedures that address compliance with rule 5b-3 and would only change these documents to the extent the fund believed the benefits justified the costs of doing so. Nevertheless, funds may consider whether to amend their repurchase agreements and policies and procedures that address compliance with rule 5b-3, including making technical changes to these documents in response to the proposed amendments, if adopted. As noted above, we estimate that funds would incur a one-time aggregate cost of $2,944,080 to make any of these changes.[111]

- We request comment on these cost estimates. Do commenters foresee additional or alternative costs if the proposed amendments to rule 5b-3 are adopted? Have we accurately estimated costs of amending repurchase agreements and policies and procedures for the evaluation of the credit quality and liquidity of collateral securities?

C. Proposed Rule 6a-5

We are proposing new rule 6a-5, which would establish a credit-worthiness standard under section 6(a)(5)(A)(iv)(I) of the Investment Company Act. BIDCOs that seek to rely on the exemption in section 6(a)(5) of the Act would be limited to investing in debt securities issued by investment companies and private funds if, at the time of purchase, the board of directors or members of the BIDCO (or their delegate) determines that the debt security is (i) subject to no greater than moderate credit risk and (ii) sufficiently liquid that the security can be sold at or near its carrying value within a reasonably short period of time.

1. Benefits

We anticipate that proposed rule 6a-5 would result in certain benefits. Our proposed standard is intended to achieve the same purpose as the credit rating it would replace. In particular, the proposed standard is designed to limit BIDCOs to purchasing debt securities issued by investment companies or private funds of sufficiently high credit quality that they are likely to maintain a fairly stable market value and may be liquidated easily, as appropriate, for the BIDCO to support its investment and financing activities.

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111 *See supra* note 95 and accompanying text.

Furthermore, to comply with the proposed standard, we do not believe that BIDCOs would be required to change any policies and procedures they may have with respect to the evaluation of these debt securities. As noted above, under proposed rule 6a-5, in evaluating whether debt securities issued by investment companies and private funds present moderate credit risk, boards of directors and members of BIDCOs (or their delegates) would be able to consider credit quality determinations prepared by outside sources, including NRSRO ratings, that they conclude are credible and reliable for purposes of making these determinations. We expect that the ability to consider outside assessments in making these determinations would help minimize the burden on BIDCOs and contribute to a BIDCO's ability to make consistent credit quality determinations.

2. *Costs*

We recognize that BIDCOs may incur some costs if we adopted proposed rule 6a-5. These may be internal costs or costs to consult outside legal counsel to evaluate whether changes to any policies and procedures the BIDCOs may have currently for acquiring debt securities issued by investment companies or private funds may be appropriate in light of the proposed rule. We do not believe, however, that these costs are attributable to the proposed rule because the Dodd-Frank Act's replacement of the credit rating standard in the Investment Company Act with a standard to be adopted by the Commission would result in similar costs of evaluating compliance with a new credit quality standard.

We expect that, although not required by the Investment Company Act, as a matter of good business practice, directors or members of most BIDCOs that do not currently have them may prepare policies and procedures to make the credit quality and liquidity determinations required by the proposed rule. Commission staff estimates that the costs of preparing the procedures for making determinations of credit quality and liquidity under the rule would be borne upfront. Once generated, reviewed and implemented by directors or members of BIDCOs (or their delegates), directors and members (or their delegates) would be able to follow them for purposes of making future determinations under the rule. Our staff has estimated that each BIDCO would incur, on average, an initial one-time cost of $928 to prepare policies and procedures and an average of $928 in annual costs for making credit determinations with respect to the acquisition of debt securities.[112]

We anticipate that many BIDCOs that invest cash in these types of debt securities would continue to consider credit quality determinations prepared by outside sources, including NRSRO ratings, that they conclude are credible and reliable for purposes of making these determinations. Nevertheless, we recognize that some BIDCO boards or members may choose to hire consultants to assist in developing procedures and to make or oversee the proposed determinations.[113] Staff estimates that the cost to hire such consultants would be, on average, $8000 for each BIDCO.[114]

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112 We estimate that each BIDCO would incur on average a one-time burden of 4 hours for a senior business analyst (under board or member delegation) to develop policies and procedures for evaluating credit and liquidity risk (4 hours x $232 per hour = $928). Commission staff believes that additional costs incurred by boards or members for review of procedures would be incorporated into BIDCOs' overall board or member costs and would not add any particular costs. In addition, Commission staff estimates that a BIDCO board or member is likely to delegate the credit risk determinations, and that such determinations would take on average 1 hour of a senior business analyst's time (at $232 per hour) to evaluate the credit quality for each of an average of 4 investment company or private fund debt securities that a BIDCO would purchase each year (4 hours x $232 per hour) for a total cost of $928 per year.

113 We do not expect that money market funds would incur similar development assistance costs with respect to the proposed amendments to rule 2a-7 because rule 2a-7 currently requires these funds to perform credit quality determinations with respect to portfolio securities. Similarly, we expect that funds that rely on rule 5b-3 currently incorporate credit quality standards for collateral securities in addition to ratings in their repurchase agreements.

114 Staff estimates that a BIDCO would need up to 16 hours of consulting advice to assist in developing procedures and to make or oversee the proposed determinations. Staff estimates that this advice would cost a BIDCO $500 per hour based on an understanding of the rates typically

- We request comment on these cost estimates. Are the costs estimates accurate regarding the proposed procedures for making credit quality determinations? Do commenters foresee additional or alternative costs if proposed rule 6a-5 were adopted?

D. Forms N-1A, N-2 and N-3

The proposed amendments to Forms N-1A, N-2 and N-3 would eliminate the required use of NRSRO credit ratings by funds that choose to use credit quality categorizations in the required table, chart, or graph of portfolio holdings. If a fund chooses to use NRSRO credit ratings to depict credit quality of portfolio holdings, the proposed amendments, like the current forms, generally would require the fund to use the credit ratings of a single NRSRO. The proposed amendments would clarify that, if credit ratings of the NRSRO selected by a fund are not available for certain holdings, the fund must briefly discuss the methodology for determining credit quality for those holdings, including, if applicable, the use of credit ratings assigned by another NRSRO.

1. Benefits

Under the proposed amendments, funds will have greater flexibility to depict credit quality in the most meaningful manner, which may lead to better information for investors. This largely results from the congressionally mandated removal of the required use of credit ratings under section 939A of the Dodd-Frank Act.

2. Costs

The Commission believes that because the proposed amendments only eliminate the required use of NRSRO credit ratings by funds that choose to use credit quality categorizations, any cost imposed on funds would not be material. Funds might incur costs to the extent that they

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charged by outside consulting firms.

choose to develop new methodologies for depicting credit quality. If a fund chooses to use NRSRO credit ratings to depict credit quality of portfolio holdings, the proposed amendments would clarify that, if credit ratings of the NRSRO selected by a fund are not available for certain holdings, the fund must briefly discuss the methodology for determining credit quality for those holdings. The Commission believes that the proposed clarification would not impose any additional cost because funds typically provide this disclosure in their shareholder reports today.[115]

E. Request for Comment

The Commission requests comments on all aspects of the cost-benefit analysis, including the accuracy of the potential costs and benefits identified and assessed in this Release, as well as any other costs or benefits that may result from the proposals. We encourage commenters to identify, discuss, analyze, and supply relevant data regarding these or additional costs and benefits. For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,[116] the Commission also requests information regarding the potential annual effect of the proposals on the U.S. economy. Commenters are requested to provide empirical data to support their views.

VI. CONSIDERATION OF PROMOTION OF EFFICIENCY, COMPETITION AND CAPITAL FORMATION

Section 2(c) of the Investment Company Act and section 2(b) of the Securities Act each requires the Commission, when engaging in rulemaking under the respective Act that requires it to consider or determine whether an action is consistent with or necessary or appropriate in the

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[115] This assessment is based on a staff review of a sample of fund shareholder reports filed with the Commission.

[116] Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[117]

Our proposed amendments to rules 2a-7 and 5b-3 and Forms N-MFP, N-1A, N-2 and N-3 implement provisions of the Dodd-Frank Act that call for the Commission to remove credit rating references in its regulations and to substitute other appropriate standards of credit-worthiness in place of the credit ratings. Thus, effects on efficiency, competition, and capital formation that arise from the removal of credit ratings are attributable to the congressionally mandated removal of the required use of credit ratings under section 939A of the Dodd-Frank Act. The Commission has discretion, however, to adopt rule and rule amendments that set forth the alternative standards of credit-worthiness, and we undertake below to discuss the effects on efficiency, competition and capital formation of the specific standards that we are proposing.

We do not believe that the proposed amendments to rules 2a-7 and 5b-3 and Forms N-MFP, N-1A, N-2 and N-3 would significantly affect competition or have an adverse effect on efficiency or capital formation.

Rule 2a-7. With respect to rule 2a-7, as we have discussed above, money market funds have procedures for making credit quality and credit risk determinations under current rule 2a-7. In addition, we have designed the proposed standard to retain a degree of risk limitation similar to that reflected by the credit ratings in the current rule. Because we do not anticipate that the proposed amendments are likely to change the types of investments that are made by money market funds, we do not believe that the proposed amendments would have a significant effect on competition or capital formation. As we have noted above, we believe that money market

117 15 U.S.C. 80a-2(c); 15 U.S.C. 77b(b).

funds could change their policies and procedures to reflect changes in the proposed amendments or continue to rely on their current policies and procedures to comply with the proposed amendments. We expect that money market funds are likely to make changes only if the benefits of such changes would justify the costs, which would not be likely to have an adverse effect on efficiency.

Form N-MFP. The proposed amendments would conform the disclosures in Form N-MFP to the proposed amendments to rule 2a-7. We do not believe that our proposal to remove certain disclosures from the form would change the types of securities money market funds invest in and, therefore, would have no effect on competition or capital formation. To the extent that the proposed amendments reduce the time funds spend making the disclosures required in Form N-MFP, the proposed amendments may slightly increase efficiency.

Rule 5b-3. The proposed standard for determining the credit quality of collateral securities in rule 5b-3 is designed to achieve the same purpose as the credit rating reference in the existing rule, *i.e.*, to limit collateral securities to those that are likely to retain a stable market value and that, under ordinary circumstances, the fund could liquidate quickly in the event of a counterparty default. Because we do not anticipate that the proposed amendments would change the types of collateral securities that funds relying on 5b-3 would use, we do not believe that the proposed amendments would have a significant effect on competition or capital formation. Furthermore, funds typically establish credit quality standards for collateral securities that include credit ratings in repurchase agreements they enter into with counterparties. Funds could change their policies and procedures to reflect changes in the proposed amendments, but the rule would not prohibit funds from relying on the standards in current repurchase agreements and policies and procedures that address compliance with rule 5b-3. We anticipate that the consideration of outside sources in making credit quality determinations with respect to collateral securities may help funds arrive at consistent credit quality determinations. For these reasons, we do not believe that the proposed amendments to rule 5b-3 would have a significant effect on efficiency.

Forms N-1A, N-2 and N-3. The proposed amendments to Forms N-1A, N-2 and N-3 would eliminate the required use of NRSRO ratings by funds that choose to use credit quality categorizations in the required table, chart, or graph of portfolio holdings. If a fund chooses to use NRSRO credit ratings to depict credit quality of portfolio holdings, the proposed amendments would clarify that, if credit ratings of the NRSRO selected by a fund are not available for certain holdings, the fund must briefly discuss the methodology for determining credit quality for those holdings, including, if applicable, the use of credit ratings assigned by another NRSRO. We do not believe that the proposed clarification would affect efficiency, competition or capital formation because funds typically provide this disclosure in their shareholder reports today.[118] The effect, if any, on efficiency, competition and capital formation that would arise from the proposed amendments to Forms N-1A, N-2 and N-3 results from the congressionally mandated removal of the required use of credit ratings under section 939A of the Dodd-Frank Act.

Request for comment. We request comment whether the proposed rule and rule and form amendments would, if adopted, promote efficiency, competition, and capital formation. Commenters are requested to provide empirical data to support their views.

118 This assessment is based on a staff review of fund shareholder reports filed with the Commission.

VII. Regulatory Flexibility Act Certification

Pursuant to section 5(b) of the Regulatory Flexibility Act,[119] the Commission hereby certifies that the proposed amendments to rule 2a-7 and Form N-MFP under the Investment Company Act would not, if adopted, have a significant economic impact on a substantial number of small entities. For purposes of the RFA, an investment company is a small entity if it, together with other investment companies in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year.[120] Based on information in filings submitted to the Commission, we believe that there are no money market funds that are small entities. For this reason, the Commission believes that the amendments to rule 2a-7 and Form N-MFP under the Investment Company Act would not, if adopted, have a significant economic impact on a substantial number of small entities.

The Commission requests written comments regarding this certification. The Commission requests that commenters describe the nature of any impact on small businesses and provide empirical data to support the extent of the impact.

VIII. Initial Regulatory Flexibility Analysis

The Commission has prepared the following Initial Regulatory Flexibility Analysis ("IRFA") in accordance with section 3(a) of the Regulatory Flexibility Act.[121] It relates to the Commission's proposed amendments to rule 5b-3 under the Investment Company Act and Forms N-1A, N-2 and N-3 under the Investment Company Act and Securities Act and proposed rule 6a-5 under the Investment Company Act.

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119 5 U.S.C. 605(b).

120 17 CFR 270.0-10(a).

121 5 U.S.C. 603(a).

A. Objectives and Legal Basis

As described more fully in Sections I and II of this Release, to implement section 939A of the Dodd-Frank Act, the Commission is proposing to amend (i) rule 5b-3 to eliminate references to the credit rating and replace it with an alternative standard of credit-worthiness that is designed to appropriately achieve the same purpose as the use of the credit rating and (ii) Forms N-1A, N-2 and N-3 to eliminate the required use of NRSRO credit ratings by funds that choose to use credit quality categorizations in the required table, chart, or graph of portfolio holdings in their shareholder reports. The Commission is also proposing new rule 6a-5 to set forth a standard of credit-worthiness for purposes of section 6(a)(5)(A)(iv) of the Act, as anticipated by the Dodd Frank Act, which eliminates the investment grade standard from section 6(a)(5) of the Investment Company Act.

The Commission is proposing amendments to rule 5b-3 pursuant to our authority set forth in sections 6(c) and 38(a) of the Investment Company Act [15 U.S.C. 80a-6(c), 80a-37(a)] and section 939A of the Dodd-Frank Act. The Commission is proposing rule 6a-5 pursuant to our authority set forth in section 38(a) of the Investment Company Act [15 U.S.C. 80a-37(a)] and section 939 of the Dodd-Frank Act, codified at section 6(a)(5)(A)(iv)(I) of the Investment Company Act [15 U.S.C. 80a-6(a)(5)(A)(iv)(I)]. The Commission is proposing amendments to Forms N-1A, N-2 and N-3 pursuant to the authority set forth in sections 5, 6, 7, 10 and 19(a) of the Securities Act and sections 8, 24(a), 30 and 38 of the Investment Company Act.

B. Small Entities Subject to the Rule

The proposed amendments to rule 5b-3 and proposed rule 6a-5 under the Investment Company Act would affect funds and BIDCOs, respectively, including entities that are considered to be a small business or small organization (collectively, "small entity") for purposes of the Regulatory Flexibility Act.

Investment Companies. For purposes of the Regulatory Flexibility Act, an investment company is a small entity if it, together with other investment companies in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year.[122] Based on a review of filings submitted to the Commission, we estimate that 181 investment companies may be considered small entities and that all of these investment companies may potentially rely on rule 5b-3.[123] We estimate that approximately 150 investment companies that meet the definition of small entity would be subject to the proposed amendments to Forms N-1A, N-2 and N-3.

BIDCOs. Under the standards adopted by the Small Business Administration, small entities in the financial investment industry include entities with $7 million or less in annual receipts.[124] We do not have any data and are not aware of any databases that compile information regarding how many BIDCOs would be small entities under this definition. We request comment on how many BIDCOs are small entities under this definition.

C. Reporting, Recordkeeping, and Other Compliance Requirements

Rule 5b-3. We propose to amend rule 5b-3 to allow a fund to treat the acquisition of a repurchase agreement as an acquisition of securities collateralizing the repurchase agreement for purposes of sections 5(b)(1) and 12(d)(3) of the Act if the collateral other than cash or government securities consists of securities that the fund's board of directors (or its delegate)

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122 17 CFR 270.0-10(a).

123 The 181 investment companies that meet the definition of small entity include business development companies, which are subject to sections 5 and 12 of the Investment Company Act. 15 U.S.C. 80a-58; 15 U.S.C. 80a-59.

124 13 CFR 121.201.

determines at the time the repurchase agreement is entered into are: (i) issued by an issuer that has the highest capacity to meet its financial obligations; and (ii) sufficiently liquid that they can be sold at approximately their carrying value in the ordinary course of business within seven days. A fund that acquires repurchase agreements and intends the acquisition to be treated as an acquisition of the collateral securities must adopt and implement written policies and procedures reasonably designed to comply with the conditions of rule 5b-3, including any credit quality or liquidity requirements that we adopt.[125]

We have estimated the costs of these amendments previously in the cost-benefit analysis in Section V above.[126]

Proposed rule 6a-5. Proposed rule 6a-5 would impose no reporting, recordkeeping or other compliance requirements.

Forms N-1A, N-2 and N-3. The proposed amendments to Forms N-1A, N-2 and N-3 would apply to open-end management investment companies, closed-end management investment companies and separate accounts organized as management investment companies that offer variable annuity contracts, including those that are small entities. We are proposing to amend the forms to eliminate the required use of NRSRO credit ratings by funds that choose to use credit quality categorizations in the required table, chart, or graph of portfolio holdings in their shareholder reports. If a fund chooses to use NRSRO credit ratings to depict credit quality of portfolio holdings, the proposed amendments, like the current forms, generally would require the fund to use the credit ratings of a single NRSRO. The proposed amendments would clarify that, if credit ratings of the NRSRO selected by a fund are not available for certain holdings, the fund must briefly discuss the methodology for determining credit quality for those holdings,

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125 17 CFR 270.38a-1(a).

126 *See supra* Section V.B.2.

including, if applicable, the use of credit ratings assigned by another NRSRO. For purposes of the cost-benefit analysis, we have estimated that any cost imposed on funds would not be material.

D. Duplicating, Overlapping, or Conflicting Federal Rules

Rule 31a-1 under the Act requires the retention of ledger accounts for each portfolio security and each person through which a portfolio transaction is effected, including certain records of collateral for monies borrowed and loaned.[127] Although some of the procedures under the proposed amendments to rule 5b-3 may overlap with information in the ledgers, we believe any overlap would be minimal and the rule 5b-3 procedures would contain additional information specifically related to the concerns underlying these rules. The Commission believes that there are no other rules that duplicate, overlap, or conflict with the proposed amendments to Forms N-1A, N-2 and N-3 and proposed new rule 6a-5.

E. Significant Alternatives

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish our stated objectives, while minimizing any significant adverse impact on small issuers. In connection with the proposed rule and rule and form amendments, the Commission considered the following alternatives: (i) establishing different compliance standards or timetables that take into account the resources available to small entities; (ii) clarifying, consolidating, or simplifying compliance and reporting requirements under the rule for small entities; (iii) use of performance rather than design standards; and (iv) exempting small entities from all or part of the requirements.

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127 *See* rule 31a-1(b)(2)(i)(d).

The Commission believes that, at the present time, special compliance or reporting requirements for small entities, or an exemption from coverage for small entities, would not be appropriate or consistent with investor protection. The proposed rule and amendments to rules and forms are intended to implement sections 939 and 939A of the Dodd-Frank Act. We believe that, with respect to rule 5b-3, different credit quality standards, special compliance requirements or timetables for small entities, or an exemption from coverage for small entities, may create a risk that those entities could acquire repurchase agreements with collateral that is less likely to retain its market value or liquidity in the event of a counterparty default. Similarly, with respect to proposed rule 6a-5, we believe that special compliance requirements or timetables for small entities, or an exemption from coverage for small entities, may create a risk that those BIDCOs could acquire debt securities that are not of sufficiently high credit quality that they would be likely to maintain a fairly stable market value or be liquidated easily, as we believe may have been intended for the BIDCO to support its long-term commitments. Further consolidation or simplification of the proposals for funds that are small entities would be inconsistent with the Commission's goals of fostering investor protection.

The proposed form amendments, if adopted, would apply to all investment companies that use Forms N-1A, N-2 and N-3 to register under the Investment Company Act and to offer their securities under the Securities Act. If the Commission excluded small entities from the proposed form amendments, small entities would be required to use NRSRO credit ratings if they choose to depict credit quality, while other entities would not be subject to that requirement. We believe this outcome is inconsistent with section 939A of the Dodd-Frank Act. We believe that special compliance or reporting requirements, or an exemption, for small entities would not be appropriate because the proposed requirement – that if a fund chooses to use NRSRO credit ratings to depict credit quality of portfolio holdings, generally it must use the ratings of a single NRSRO – is intended to eliminate the possibility that a fund of any size could choose to use NRSRO credit ratings and then select the most favorable ratings among credit ratings assigned by multiple NRSROs.

We have endeavored through the proposed form amendments to minimize regulatory burden on investment companies, including small entities, while meeting our regulatory objectives. We have endeavored to clarify, consolidate, and simplify the requirements applicable to investment companies, including those that are small entities. Finally, the proposal would use performance rather than design standards for determining the credit quality of specific securities.

For these reasons, we have not proposed alternatives to the proposed rule and rule and form amendments.

F. Request for Comments

We encourage the submission of comments with respect to any aspect of the IRFA. In particular, the Commission seeks comment on the number of small entities that would be subject to the proposed rule and rule and form amendments and whether the effect of the proposed rule on small entities subject to it would be economically significant. Commenters are asked to describe the nature of any impact and provide empirical data supporting its extent. These comments will be considered in connection with any adoption of the proposed rule and rule and form amendments, and reflected in a Final Regulatory Flexibility Analysis.

Comments should be submitted in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090. Comments may also be submitted electronically to the following e-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7-7-11, and this file number should be included on the subject line if e-mail is used.[128] Comment letters will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549-1520, on official business days between the hours of 10 a.m. and 3 p.m. Electronically submitted comment letters also will be posted on the Commission's Internet website (http://www.sec.gov).

STATUTORY AUTHORITY

The Commission is proposing amendments to rules 2a-7 and 5b-3 under the authority set forth in sections 6(c) and 38(a) of the Investment Company Act [15 U.S.C. 80a-6(c), 80a-37(a)] and section 939A of the Dodd-Frank Act. The Commission is proposing new rule 6a-5 under the authority set forth in section 38(a) of the Investment Company Act [15 U.S.C. 80a-37(a)] and section 939 of the Dodd-Frank Act, to be codified at section 6(a)(5)(A)(iv)(I) of the Investment Company Act [15 U.S.C. 80a-6(a)(5)(A)(iv)(I)]. The Commission is proposing amendments to Form N-1A, Form N-2 and Form N-3 under the authority set forth in sections 5, 6, 7, 10 and 19(a) of the Securities Act [15 U.S.C. 77e, 77f, 77g, 77j, and 77s(a)] and sections 8, 24(a), 30 and 38 of the Investment Company Act [15 U.S.C. 80a-8, 80a-24(a), 80a-29 and 80a-37]. The Commission is proposing amendments to Form N-MFP under the authority set forth in sections 8(b), 30(b), 31(a) and 38(a) of the Investment Company Act [15 U.S.C. 80a-8(b), 80a-29(b), 80a-30(a) and 80a-37(a)] and section 939A of the Dodd-Frank Act.

List of Subjects

17 CFR Part 239

Reporting and recordkeeping requirements, Securities.

17 CFR Parts 270 and 274

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128 Comments on the IRFA will be placed in the same public file that contains comments on the proposed rule and rule and form amendments.

Investment companies, Reporting and recordkeeping requirements, Securities.

TEXT OF PROPOSED RULE AND FORM AMENDMENTS

For reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 239—FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

1. The authority citation for Part 239 continues to read in part as follow:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z–2, 77z–3, 77sss, 78c, 78l, 78m, 78n, 78o(d), 78u–5, 78w(a), 78ll, 78mm, 80a–2(a), 80a–3, 80a–8, 80a–9, 80a–10, 80a–13, 80a–24, 80a–26, 80a–29, 80a–30, and 80a–37, unless otherwise noted.

* * * * *

PART 270--RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

2. The authority citation for Part 270 is revised to read in part as follows:

Authority: 15 U.S.C. 80a-1 *et seq.*, 80a-34(d), 80a-37, and 80a-39, unless otherwise noted.

* * * * *

Section 270.6a-5 is also issued under 15 U.S.C. 80a-6(a)(5)(A)(iv)(I).

* * * * *

3. Section 270.2a-7 is amended by:

a. In paragraph (a)(5), removing the words "and (D)";

b. Removing paragraph (a)(11);

c. Redesignating paragraphs (a)(12) through (a)(20) as (a)(11) through (a)(19);

d. Revising newly designated paragraph (a)(11);

e. Revising newly designated paragraph (a)(13);

f. Removing paragraph (a)(21);

g. Redesignating paragraph (a)(22) as paragraph (a)(20);

h. Removing paragraph (a)(23);

i. Redesignating paragraphs (a)(24) through (a)(29) as paragraphs (a)(21) through (a)(26);

j. Removing paragraph (a)(30);

k. Redesignating paragraphs (a)(31) and (a)(32) as paragraphs (a)(27) and (a)(28);

l. Revising paragraphs (c)(3)(i), (c)(3)(iii), and (c)(3)(iv)(C);

m. Adding paragraph (c)(3)(iv)(D);

n. In paragraph (c)(7):

i. Revising the paragraph heading;

ii. Revising paragraph (c)(7)(i);

iii. In the introductory text of paragraph (c)(7)(ii), revising the phrase "paragraphs (c)(7)(ii)(A) through (D)" to read paragraphs (c)(7)(ii)(A) through (C)";

iv. Adding "or" at the end of paragraph (c)(7)(ii)(B);

v. Removing paragraph (c)(7)(ii)(C) and redesignating paragraph (c)(7)(ii)(D) as paragraph (c)(7)(ii)(C);

o. Revising paragraph (c)(10)(v)(A);

p. Revising paragraph (c)(11)(iii);

q. In paragraph (e):

i. Removing the words "(a)(11)(i) (designation of NRSROs)"; and

ii. Revising paragraph (e)(1).

These additions and revisions read as follows:

§ 270.2a-7 Money market funds.

(a) * * *

(11) *Eligible Security* means a security with a remaining maturity of 397 calendar days or less that the fund's board of directors determines presents minimal credit risks (which determination must be based on factors pertaining to credit quality and the issuer's ability to meet its short-term financial obligations).

* * * * *

(13) *First Tier Security* means any Eligible Security:

(i) The issuer of which the fund's board of directors has determined has the highest capacity to meet its short-term financial obligations;

(ii) That is a security issued by a registered investment company that is a money market fund; or

(iii) That is a Government Security.

* * * * *

(c) * * *

(3) * * *

(i) *General.* The money market fund shall limit its portfolio investments to those United States Dollar-Denominated securities that are at the time of Acquisition Eligible Securities.

* * * * *

(iii) *Securities Subject to Guarantees.* A security that is subject to a Guarantee may be determined to be an Eligible Security or a First Tier Security based solely on whether the Guarantee is an Eligible Security or First Tier Security, as the case may be, *provided however*, that the issuer of the Guarantee, or another institution, has undertaken to promptly notify the holder of the security in the event the Guarantee is substituted with another Guarantee (if such substitution is permissible under the terms of the Guarantee).

(iv) * * *

* * * * *

(C) The fund's board of directors determines that the Underlying Security or any Guarantee of such security is of high quality and subject to very low credit risk; and

(D) The issuer of the Conditional Demand Feature, or another institution, has undertaken to promptly notify the holder of the security in the event the Conditional Demand Feature is substituted with another Conditional Demand Feature (if such substitution is permissible under the terms of the Conditional Demand Feature).

* * * * *

(7) *Monitoring, Defaults and Other Events.*

(i)(A) *Monitoring.* In the event the money market fund's investment adviser (or any person to whom the fund's board of directors has delegated portfolio management responsibilities) becomes aware of any credible information about a portfolio security or an issuer of a portfolio security that may suggest that the security is no longer a First Tier Security or a Second Tier Security, as the case may be, the board of directors shall reassess promptly whether such security continues to present minimal credit risks and shall cause the fund to take such action as the board of directors determines is in the best interests of the money market fund and its shareholders. This reassessment shall not be required if the fund disposes of the security (or it matures) within five Business Days after the date the money market fund's adviser (or any person to whom the fund's board of directors has delegated portfolio management responsibilities) becomes aware of the relevant information, and the board is subsequently notified of the adviser's actions.

(B) *Special Rule for Certain Securities Subject to Demand Features.* If, as a result of a portfolio security that ceases to be a First Tier Security, more than 2.5 percent of the fund's Total Assets are invested in securities issued by or subject to Demand Features from a single institution that are Second Tier Securities, the fund shall reduce its investment in securities issued by or subject to Demand Features from that institution to no more than 2.5 percent of its Total Assets by exercising the Demand Features at the next succeeding exercise date(s), absent a finding by the board of directors that disposal of the portfolio security would not be in the best interests of the money market fund.

* * * * *

(10) * * *

(v) * * *

(A) The periodic testing, at such intervals as the board of directors determines appropriate and reasonable in light of current market conditions, of the money market fund's ability to maintain a stable net asset value per share based upon specified hypothetical events that include, but are not limited to, a change in short-term interest rates, an increase in shareholder redemptions, an adverse change in the ability of the issuer of a portfolio security to meet its short-term financial obligations or a default on portfolio securities, and the widening or narrowing of spreads between yields on an appropriate benchmark the fund has selected for overnight interest rates and commercial paper and other types of securities held by the fund.

* * * * *

(11) * * *

(iii) *Credit Risk Analysis.* For a period of not less than three years from the date that the credit risks of a portfolio security were most recently reviewed, a written record of the determination that a portfolio security presents minimal credit risks used to determine the status of the security as an Eligible Security shall be maintained and preserved in an easily accessible place.

* * * * *

(e) * * *

(1) *Written Guidelines.* The Board shall establish and periodically review written guidelines (including guidelines for determining whether securities present minimal credit risks as required in paragraph (c)(3) of this section (by reference to paragraph (a)(11)) and procedures under which the delegate makes such determinations.

4. Section 270.5b-3 is amended by:

a. Adding "or" at the end of paragraph (c)(1)(iv)(B);

b. Revising paragraph (c)(1)(iv)(C);

c. Removing paragraph (c)(1)(iv)(D);

d. Removing paragraphs (c)(5), (c)(6), and (c)(8);

e. Redesignating paragraph (c)(4) as (c)(5);

f. Adding new paragraph (c)(4); and

g. Redesignating paragraph (c)(7) as paragraph (c)(6).

The revisions read as follows:

§ 270.5b-3 Acquisition of repurchase agreement or refunded security treated as acquisition of underlying securities.

* * * * *

(c) * * *

(1) * * *

(iv) * * *

(C) Securities that the investment company's board of directors, or its delegate, determines at the time the repurchase agreement is entered into:

(1) Each issuer of which has the highest capacity to meet its financial obligations; and

(2) Are sufficiently liquid that they can be sold at approximately their carrying value in the ordinary course of business within seven calendar days; and

* * * * *

(4) *Issuer*, as used in paragraph (c)(1)(iv)(C), means the issuer of a collateral security or the issuer of an unconditional obligation of a person other than the issuer of the collateral security to undertake to pay, upon presentment by the holder of the obligation (if required), the principal amount of the underlying collateral security plus accrued interest when due or upon default.

5. Section 270.6a-5 is added to read as follows:

§ 270.6a-5 Purchase of certain debt securities by companies relying on section 6(a)(5) of the Act.

For purposes of reliance on the exemption for certain companies under section 6(a)(5)(A) of the Act (15 U.S.C. 80a-6(a)(5)(A)), a company shall be deemed to have met the requirement for credit-worthiness of certain debt securities under section 6(a)(5)(A)(iv)(I) of the Investment Company Act (15 U.S.C. 80a-6(a)(5)(A)(iv)(I)) if, at the time of purchase, the board of directors (or its delegate) determines or members of the company (or their delegate) determine that the debt security is:

(a) Subject to no greater than moderate credit risk; and

(b) Sufficiently liquid that it can be sold at or near its carrying value within a reasonably short period of time.

PART 239—FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

PART 274—FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940

6. The authority citation for Part 274 continues to read in part as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78l, 78m, 78n, 78o(d), 80a–8, 80a–24, 80a–26, and 80a–29, unless otherwise noted.

*   *   *   *   *

7. Form N-1A (referenced in §§ 239.15A and 274.11A) is amended by revising Item 27(d)(2) to read as follows:

Note: The text of Form N-1A does not, and these amendments will not, appear in the Code of Federal Regulations.

FORM N-1A

*   *   *   *   *

Item 27. Financial Statements

*   *   *   *   *

(d) Annual and Semi-Annual Reports. *   *   *

(2) Graphical Representation of Holdings. One or more tables, charts, or graphs depicting the portfolio holdings of the Fund by reasonably identifiable categories (*e.g.*, type of security, industry sector, geographic region, credit quality, or maturity) showing the percentage of net asset value or total investments attributable to each. The categories and the basis of presentation (*e.g.*, net asset value or total investments) should be selected, and the presentation

should be formatted, in a manner reasonably designed to depict clearly the types of investments made by the Fund, given its investment objectives. If the Fund uses the credit ratings, as defined in section 3(a)(60) of the Securities Exchange Act [15 U.S.C. 78(c)(a)(60)], assigned by a nationally recognized statistical rating organization ("NRSRO"), as defined in section 3(a)(62) of the Securities Exchange Act [15 U.S.C. 78(c)(a)(62)], to categorize the credit quality of portfolio holdings, it should use the credit ratings of only one NRSRO except in the case of portfolio holdings that are not rated by that NRSRO. If credit ratings of that NRSRO are not available for certain holdings, the Fund must briefly discuss the methodology for determining credit quality for such holdings, including, if applicable, the use of credit ratings assigned by another NRSRO.

* * * * *

8. Form N-2 (referenced in §§ 239.14 and 274.11a-1) is amended by revising Instruction 6(a) to Item 24 to read as follows:

Note: The text of Form N-2 does not, and these amendments will not, appear in the Code of Federal Regulations.

FORM N-2

* * * * *

Item 24. Financial Statements

* * * * *

Instructions:

* * * * *

6. * * *

a. One or more tables, charts, or graphs depicting the portfolio holdings of the Registrant by reasonably identifiable categories (*e.g.*, type of security, industry sector, geographic region, credit quality, or maturity) showing the percentage of net asset value or total investments attributable to each. The categories and the basis of presentation (*e.g.*, net asset value or total investments) should be selected, and the presentation should be formatted, in a manner reasonably designed to depict clearly the types of investments made by the Registrant, given its investment objectives. If the Registrant uses the credit ratings, as defined in Section 3(a)(60) of the Exchange Act [15 U.S.C. 78(c)(a)(60)], assigned by a nationally recognized statistical rating organization ("NRSRO"), as defined in Section 3(a)(62) of the Exchange Act [15 U.S.C. 78(c)(a)(62)], to categorize the credit quality of portfolio holdings, it should use the credit ratings of only one NRSRO except in the case of portfolio holdings that are not rated by that NRSRO. If credit ratings of that NRSRO are not available for certain holdings, the Registrant must briefly discuss the methodology for determining credit quality for such holdings, including, if applicable, the use of credit ratings assigned by another NRSRO.

*   *   *   *   *

9. Form N-3 (referenced in §§ 239.17a and 274.11b) is amended by revising Instruction 6(i) to Item 28(a) to read as follows:

Note: The text of Form N-3 does not, and these amendments will not, appear in the Code of Federal Regulations.

FORM N-3

*   *   *   *   *

Item 28. Financial Statements

(a)   *   *   *

Instructions:

*   *   *   *   *

6. * * *

(i) One or more tables, charts, or graphs depicting the portfolio holdings of the Registrant by reasonably identifiable categories (*e.g.*, type of security, industry sector, geographic region, credit quality, or maturity) showing the percentage of net asset value or total investments attributable to each. If the Registrant has sub-accounts, provide the information separately for each sub-account. The categories and the basis of presentation (*e.g.*, net asset value or total investments) should be selected, and the presentation should be formatted, in a manner reasonably designed to depict clearly the types of investments made by the Registrant, given its investment objectives. If the Registrant uses the credit ratings, as defined in Section 3(a)(60) [15 U.S.C. 78c(a)(60)] of the Exchange Act, assigned by a nationally recognized statistical rating organization ("NRSRO"), as defined in Section 3(a)(62) of the Exchange Act [15 U.S.C. 78c(a)(62)], to categorize the credit quality of portfolio holdings, it should use the credit ratings of only one NRSRO except in the case of portfolio holdings that are not rated by that NRSRO. If credit ratings of that NRSRO are not available for certain holdings, the Registrant must briefly discuss the methodology for determining credit quality for such holdings, including, if applicable, the use of credit ratings assigned by another NRSRO.

* * * * *

PART 274—FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940

10. Form N-MFP (referenced in § 274.201) is amended by:

a. Revising Item 33;

b. Removing Item 34;

c. Revising Item 37.b;

d. Removing Item 37.c;

e. Removing Items 38.b and 38.c;

f. Removing Items 39.c and 39.d;

g. Redesignating Items 35 through 46 as Items 34 through 45; and

h. In redesignated Item 38, replacing "Items 37 and 38" with "Items 36 and 37".

The revision reads as follows:

Note: the text of Form N-MFP does not, and this amendment will not, appear in the Code of Federal Regulations.

FORM N-MFP

* * * * *

Item 33.

Indicate whether the security is a First Tier Security, a Second Tier Security or no longer an Eligible Security.

* * * * *

Item 37.

* * * * *

b. The period remaining until the principal amount of the security may be recovered through the Demand Feature.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy

Secretary

March 3, 2011

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34- 34-64017; File No. S7-8-11]

RIN 3235-AL13

Clearing Agency Standards for Operation and Governance

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: In accordance with Section 763 of Title VII ("Title VII") of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"), Section 805 of Title VIII ("Title VIII") of the Dodd-Frank Act, and Section 17A of the Securities Exchange Act of 1934 ("Exchange Act"), the Securities and Exchange Commission ("SEC" or "Commission") is proposing rules regarding registration of clearing agencies and standards for the operation and governance of clearing agencies.

DATES: Comments should be submitted on or before April 29, 2011.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-8-11 on the subject line; or
- Use the Federal eRulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-8-11. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/proposed.shtml). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F St., NE, Washington, DC 20549 on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Jeffrey Mooney, Assistant Director; Peter Curley, Attorney Fellow; Andrew Blake, Special Counsel; Michael Milone, Special Counsel; Alison Duncan, Attorney-Adviser; Marta Chaffee, Branch Chief; and Andrew Bernstein, Attorney-Adviser, Office of Clearance and Settlement, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-7010 at (202) 551-5710.

SUPPLEMENTARY INFORMATION: The Commission is proposing seven new rules and an amendment to an existing rule related to clearing agencies, including security-based swap clearing agencies. The proposed rules are designed to enhance the regulatory framework for the supervision of clearing agencies. Specifically, the Commission is proposing to: (1) identify certain minimum standards for all clearing agencies; (2) require dissemination of pricing and valuation information by security-based swap clearing agencies that perform central counterparty services; (3) require all clearing agencies to have adequate safeguards and procedures to protect the confidentiality of trading information of clearing agency participants; (4) exempt certain security-based swap dealers and security-based swap execution facilities from the definition of a clearing agency; (5) amend rules concerning registration of clearing agencies to account for security-based swap clearing agencies and to make other technical changes; (6) require all clearing agencies to have procedures that identify and address conflicts of interest; (7) require standards for all members of clearing agency boards of directors or committees; and (8) require all clearing agencies to designate a chief compliance officer.

I. Introduction

On July 21, 2010, President Barack Obama signed the Dodd-Frank Act into law.[1] The Dodd-Frank Act was enacted to, among other things, promote the financial stability of the United States by improving accountability and transparency in the financial system.[2] Title VII of the Dodd-Frank Act provides the Commission and the Commodity Futures Trading Commission ("CFTC") with the authority to regulate over-the-counter ("OTC") derivatives in light of the recent financial crisis, which demonstrated the need for enhanced regulation of the OTC derivatives market. The Dodd-Frank Act is intended to bolster the existing regulatory structure and to provide the Commission and the CFTC with effective regulatory tools to oversee the OTC derivatives market, which has grown exponentially in recent years and is capable of affecting significant sectors of the U.S. economy.[3]

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1 The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

2 Id. at Preamble.

3 See 156 Cong. Rec. 5878 (daily ed. July 15, 2010) (statement of Sen. Dodd).

The Dodd-Frank Act provides that the CFTC will regulate "swaps," the Commission will regulate "security-based swaps," and the CFTC and the Commission will jointly regulate "mixed swaps."[4] The Dodd-Frank Act amends the Exchange Act to require, among other things, the following: (1) transactions in security-based swaps must be cleared through a clearing agency if they are of a type that the Commission determines must be cleared, unless an exemption from mandatory clearing applies; (2) transactions in security-based swaps must be reported to a registered security-based swap data repository or the Commission; and (3) if a security-based swap is subject to a clearing requirement, it must be traded on a registered trading platform, i.e., a security-based swap execution facility or exchange, unless no facility makes such security-based swap available for trading.[5]

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4 The Commission and the CFTC, in consultation with the Board of Governors of the Federal Reserve System ("Federal Reserve"), shall jointly further define the terms "swap," "security-based swap," "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant," "eligible contract participant," and "security-based swap agreement." Pub. L. No. 111-203 § 712(d). Except for the term "eligible contract participant", these terms are defined in Sections 721 and 761 of the Dodd-Frank Act. Pub. L. No. 111-203 §§ 721, 761. The term "eligible contract participant," is defined in Section 1a(18) of the Commodity Exchange Act ("CEA"), 7 U.S.C. 1a(18), as re-designated and amended by Section 721 of the Dodd-Frank Act. Pub. L. No. 111-203 § 721. Further, Sections 721(c) and 761(b) of the Dodd-Frank Act respectively require the CFTC to adopt rules to further define the terms "swap," "swap dealer," "major swap participant," and "eligible contract participant," and permit the Commission to adopt rules to further define the terms "security-based swap," "security-based swap dealer," "major security-based swap participant," and "eligible contract participant," with regard to security-based swaps, for the purpose of including transactions and entities that have been structured to evade Title VII of the Dodd-Frank Act. Pub. L. No. 111-203 §§ 721(c), 761(b). Finally, Section 712(a) of the Dodd-Frank Act provides that the Commission and CFTC, after consultation with the Federal Reserve, shall jointly prescribe regulations regarding "mixed swaps," as may be necessary to carry out the purposes of Title VII. Pub. L. No. 111-203 § 712(a). Consistent with the Dodd-Frank statutory structure described above, the Commission and CFTC have proposed rules to define these terms. See Exchange Act No. 63452 (December 7, 2010), 75 FR 80174 (December 21, 2010).

5 Section 761 of the Dodd-Frank Act adds Section 3(a)(77) to the Exchange Act, which defines the term "security-based swap execution facility" to mean "a trading system or

Beginning in December of 2008, the Commission acted to facilitate the clearing of OTC security-based swaps by permitting certain clearing agencies to clear credit default swaps ("CDS") on a temporary conditional basis.[6] Consequently, a significant volume of security-based swaps in the form of CDS transactions are centrally cleared today, and the Commission oversees those activities pursuant to the CDS Clearing Exemption Orders.[7]

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platform in which multiple participants have the ability to execute or trade security-based swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce, including any trading facility that (A) facilitates the execution of security-based swaps between persons; and (B) is not a national securities exchange." See Pub. L. No. 111-203 § 761. The decision of a security-based swap execution facility or exchange to list a security-based swap contract for trading may not be sufficient to establish that the contract is "made available for trading" by that security-based swap execution facility or exchange and therefore cannot be traded in the over-the-counter market. See Exchange Act Release No. 63825 (February 2, 2011), 76 FR 10948 (February 28, 2011). The Dodd-Frank Act amends the CEA to provide for a similar regulatory framework with respect to transactions in swaps regulated by the CFTC.

6 The Commission authorized five entities to clear credit default swaps. See Exchange Act Release Nos. 60372 (July 23, 2009), 74 FR 37748 (July 29, 2009), 61973 (April 23, 2010), 75 FR 22656 (April 29, 2010) and 63389 (November 29, 2010), 75 FR 75520 (December 3, 2010) (CDS clearing by ICE Clear Europe Limited); 60373 (July 23, 2009), 74 FR 37740 (July 29, 2009), 61975 (April 23, 2010), 75 FR 22641 (April 29, 2010) and 63390 (November 29, 2010), 75 FR 75518 (December 3, 2010), (CDS clearing by Eurex Clearing AG); 59578 (March 13, 2009), 74 FR 11781 (March 19, 2009), 61164 (December 14, 2009), 74 FR 67258 (December 18, 2009), 61803 (March 30, 2010), 75 FR 17181 (April 5, 2010) and 63388 (November 29, 2010), 75 FR 75522 (December 3, 2010) (CDS clearing by Chicago Mercantile Exchange Inc.); 59527 (March 6, 2009), 74 FR 10791 (March 12, 2009), 61119 (December 4, 2009), 74 FR 65554 (December 10, 2009), 61662 (March 5, 2010), 75 FR 11589 (March 11, 2010) and 63387 (November 29, 2010) 75 FR 75502 (December 3, 2010) (CDS clearing by ICE Trust US LLC); 59164 (December 24, 2008), 74 FR 139 (January 2, 2009) (temporary CDS clearing by LIFFE A&M and LCH.Clearnet Ltd.) (collectively, "CDS Clearing Exemption Orders"). LIFFE A&M and LCH.Clearnet Ltd. allowed their order to lapse without seeking renewal.

7 Most cleared CDS transactions have cleared at ICE Trust US LLC ("ICE Trust") or ICE Clear Europe Limited ("ICE Clear Europe"). However, Eurex Clearing AG ("Eurex") and the Chicago Mercantile Exchange Inc. ("CME") are also authorized to operate pursuant to the CDS Clearing Exemption Orders. As of October 8, 2010, ICE Trust had cleared approximately $7.1 trillion notional amount of CDS contracts based on indices of securities and approximately $490 billion notional amount of CDS contracts based on individual reference entities or securities. As of October 8, 2010, ICE Clear Europe had

II. Prescribed Rulemaking for Clearing Agencies

A. Title VII of Dodd-Frank Act

Title VII of the Dodd-Frank Act added new provisions to the Exchange Act that require clearing agencies that clear security-based swaps ("security-based swap clearing agencies") to register with the Commission[8] and require the Commission to adopt rules with respect to security-based swap clearing agencies.[9]

Specifically, new Section 17A(j) of the Exchange Act requires the Commission to adopt rules governing security-based swap clearing agencies.[10] New Section 17A(i) of the Exchange Act also gives the Commission authority to promulgate rules that establish standards for security-based swap clearing agencies.[11] Compliance with any such rules is a prerequisite to the

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cleared approximately €3.09 trillion notional amount of CDS contracts based on indices of securities and approximately €560 billion notional amount of CDS contracts based on individual reference entities or securities. See https://www.theice.com/marketdata/reports/ReportCenter.shtml. The Commission has obtained data from The Depository Trust and Clearing Corporation on new and assigned CDS trades in United States Dollars during the month of November 2010 for ICE Trust. Cleared CDS trades represented a small fraction of total trades. Specifically, cleared trades were 5.24% by notional amount of all new or assigned single name trades, and 20.69% by notional amount of all new or assigned index trades.

8 Pub. L. No. 111-203 § 763(b) (adding subparagraph (g) to Section 17A of the Exchange Act. Pursuant to Section 774 of the Dodd-Frank Act, the requirement in Section 17A(g) of the Exchange Act for securities-based swap clearing agencies to be registered with the Commission takes effect on July 16, 2011).

9 Pub. L. No. 111-203 § 763(b) (adding subparagraphs (i) and (j) to Section 17A of the Exchange Act).

10 Pub. L. No. 111-203 § 763(b) (adding subparagraph (j) to Section 17A of the Exchange Act). See also Pub. L. No. 111-203 § 774 of the Dodd-Frank Act (requiring that the provisions of Title VII take effect on the later of 360 days after the date of the enactment or, to the extent a provision of Title VII requires a rulemaking, not less than 60 days after publication of the final rule or regulation implementing such provision).

11 Pub. L. No. 111-203 § 763(b) (adding subparagraph (i) to Section 17A of the Exchange Act).

registration of a clearing agency with the Commission and is also a condition to the maintenance of that security-based swap clearing agency's continued registration.[12]

B. Payment, Clearing, and Settlement Supervision Act of 2010

Title VIII of the Dodd-Frank Act, entitled the Payment, Clearing, and Settlement Supervision Act of 2010 ("Clearing Supervision Act"), establishes an enhanced supervisory and risk control system for systemically important clearing agencies and other financial market utilities ("FMUs").[13] It provides that the Commission may prescribe regulations containing risk management standards, taking into consideration relevant international standards and existing

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12 Under the Exchange Act, a clearing agency can be registered with the Commission only if the Commission makes a determination that the clearing agency satisfies the requirements set forth in paragraphs (A) through (I) of Section 17A(b)(3) of the Exchange Act.

13 See supra note 1. Under Section 803 of the Clearing Supervision Act, clearing agencies may be FMUs. Therefore, the Commission may be the Supervisory Agency of a clearing agency that is designated as systemically important ("designated clearing entities") by the Financial Stability Oversight Council ("Council"). See 12 U.S.C. 5463. The definition of "FMU," which is contained in Section 803(6) of the Clearing Supervision Act, contains a number of exclusions including, but not limited to, designated contract markets, registered futures associations, swap data repositories, swap execution facilities, national securities exchanges, national securities associations, alternative trading systems, security-based swap data repositories, security-based swap execution facilities, brokers, dealers, transfer agents, investment companies and futures commission merchants. 12 U.S.C. 5462(6)(B). The designation of systemic importance hinges on a determination by the Council that the failure of, or a disruption to, the functioning of the FMU could create, or increase, the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threaten the stability of the financial system of the United States. See 12 U.S.C. 5463(a)(2)(A)-(E). The designation of an FMU is significant, in part, because it will subject such designated entity to heightened oversight consistent with the terms of the Clearing Supervision Act. For example, the Clearing Supervision Act requires the Supervisory Agency to examine at least once annually any FMU that the Council has designated as systemically important. The Commission intends to conduct such annual statutory cycle examinations on the Commission's fiscal year basis. The Commission staff anticipates conducting the first annual statutory cycle examination of any designated FMU for which it is the Supervisory Agency in the annual cycle following such designation.

prudential requirements, for any designated clearing entities it regulates.[14] The Council has not to date made any designations with respect to whether any FMU is, or is likely to become, systemically important; [15] however, the Commission believes it is beneficial to consider the requirements of the Clearing Supervision Act in its proposed rules for clearing agencies because the Clearing Supervision Act may apply to one or more clearing agencies in the future and the Commission preliminarily believes that its goals are consistent with the goals of Section 17A of the Exchange Act. Specifically, Congress recognized in the Clearing Supervision Act that the operation of multilateral payment, clearing or settlement activities may reduce risks for clearing participants and the broader financial system, while at the same time creating new risks that require multilateral payment, clearing or settlement activities to be well-designed and operated in a safe and sound manner.[16] The Clearing Supervision Act is designed, in part, to provide a regulatory framework to help deal with such risk management issues, which is generally consistent with the Exchange Act requirement that clearing agencies be organized in a manner so

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14 See Section 805(a)(2) of the Clearing Supervision Act. Those regulations may govern "(A) the operations related to payment, clearing, and settlement activities of such designated clearing entities; and (B) the conduct of designated activities by such financial institutions." 12 U.S.C. 5464(a)(2).

15 See 12 U.S.C 5321 (among other things establishing the Council and designating its voting and nonvoting members. In accordance with Section 804 of the Clearing Supervision Act, the Council has the authority, on a non-delegable basis and by a vote of not fewer than two-thirds of the members then serving, including the affirmative vote of its chairperson, to designate those FMUs that the Council determines are, or are likely to become, systemically important. The Council may, using the same procedures as discussed above, rescind such designation if it determines that the FMU no longer meets the standards for systemic importance. Before making either determination, the Council is required to consult with the Federal Reserve and the relevant Supervisory Agency as determined in accordance with Section 803(8) of the Clearing Supervision Act). See also Section 804 setting forth the procedures for giving entities 30 days advance notice and the opportunity for a hearing prior to being designated as systemically important. 12 U.S.C. 5463.

16 12 U.S.C. 5461(a)(2).

as to facilitate prompt and accurate clearance and settlement, safeguard securities and funds and protect investors.[17]

C. Section 17A of Exchange Act

As noted above, in addition to the new authority provided to the Commission under Titles VII and VIII of the Dodd-Frank Act, the Commission has existing authority over clearing agencies under the Exchange Act. For example, entities are required to register with the Commission pursuant to Section 17A of the Exchange Act[18] and Rule 17Ab2-1,[19] prior to performing the functions of a clearing agency. Under this registration system, the Commission is not permitted to grant registration unless it determines that the rules and operations of the clearing agency meet the standards set forth in Section 17A.[20] If a clearing agency is granted registration, the Commission oversees the clearing agency to facilitate compliance with the Exchange Act through the rule filing process for self-regulatory organizations ("SROs") and through on-site examinations by Commission staff. Section 17A also gives the Commission authority to adopt rules for clearing agencies as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act

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17 See 15 U.S.C. 78q-1(b)(3)(A).

18 See 15 U.S.C. 78q-1(b). See also Pub. L. No 111-203 § 763(b) (adding subparagraph (g) to Section 17 of the Exchange Act).

19 See 17 CFR 240.17b2-1.

20 Specifically, Sections 17A(b)(3)(A)-(I) identify determinations that the Commission must make about the rules and structure of a clearing agency prior to granting registration. See 15 U.S.C. 78q-1(b)(3)(A)-(I). The staff of the Commission provided guidance on meeting the requirements of Section 17A in its Announcement of Standards for the Registration of Clearing Agencies. See Exchange Act Release No. 16900 (June 17, 1980), 45 FR 41920 (June 23, 1980).

and prohibits a registered clearing agency from engaging in any activity in contravention of these rules and regulations.[21]

III. Proposed Rules Governing Clearing Agencies

The Commission is proposing several new rules that would set standards for the operation and governance of clearing agencies. As noted above, the Dodd-Frank Act specifically gives the Commission authority to regulate security-based swaps[22] and to adopt regulations addressing risk management standards for designated clearing entities that the Commission regulates. In addition to considering this specific directive in formulating the proposed rules, the Commission preliminarily believes that applying certain rules to all clearing agencies would promote financial stability, one of the goals of the Dodd-Frank Act, by facilitating prompt and accurate clearance and settlement of all securities transactions consistent with Section 17A of the Exchange Act while promoting the Dodd-Frank Act's stated aims of accountability and transparency.

The types of clearing agencies that are subject to the proposed rules can be divided into four different categories: (i) clearing agencies that offer central counterparty ("CCP") services for transactions in securities that are not security-based swaps, (ii) clearing agencies that offer CCP services for transactions in securities that are security-based swaps; (iii) clearing agencies that provide non-CCP services for transactions in securities that are not security-based swaps; and (iv) clearing agencies that provide non-CCP services for transactions in securities that are security-based swaps. The table below illustrates how the proposed rules would apply to different types of clearing agencies. In general, as illustrated in column "A" in the table, clearing agencies offering CCP services (regardless of whether they offer those services for transactions

21 See 15 U.S.C. 78q-1(d).

22 See supra note 4.

in securities that are or are not security-based swaps) would be subject to most of the proposed rules.[23] Clearing agencies that offer only non-CCP services would only be subject to certain of the proposed rules, depending on whether they offer those services for transactions in securities that are not security-based swaps (as illustrated in column "B" in the table)[24] or that are security-based swaps (as illustrated in column "C" in the table).

Application of Proposed Rules to Clearing Agencies			
	A **CCP Clearing Services for Securities that are or are not Security-Based Swaps ("SBS")**	**B** **Non-CCP Clearing Services in Securities that are not SBS**	**C** **Non-CCP Clearing Services for Securities that are SBS**
17Ad-22 (b)(1): Measurement and management of credit exposures	○		
17Ad-22 (b)(2): Margin requirements	○		
17Ad-22 (b)(3): Financial resources	○		
17Ad-22 (b)(4): Model validation	○		
17Ad-22 (b)(5): Non-dealer access	○		
17Ad-22 (b)(6): Portfolio size and transaction volume thresholds restrictions	○		
17Ad-22 (b)(7): Net capital restrictions	○		
17Ad-22 (c)(1): Records of financial resources	○		
17Ad-22 (c)(2): Audited financial statements	○	○	○
17Ad-22 (d)(1): Transparent and enforceable rules	○	○	○
17Ad-22 (d)(2): Participation requirements	○	○	○

23 As noted in the table, proposed Rule 17Aj-1 would only apply to CCPs for security-based swap transactions.

24 Within this category, as illustrated in column "B", the proposed rules distinguish between clearing agencies that provide central securities depository services, and those that do not.

17Ad-22 (d)(3): Custody of assets and investment risk	O	O	O
17Ad-22 (d)(4): Identification and mitigation of operational risk	O	O	O
17Ad-22 (d)(5): Money settlement risks	O	O	O
17Ad-22 (d)(6): Cost-effectiveness	O	O	O
17Ad-22 (d)(7): Links	O	O	O
17Ad-22 (d)(8): Governance	O	O	O
17Ad-22 (d)(9): Information on services	O	O	O
17Ad-22 (d)(10): Immobilization and dematerialization of stock certificates		**Would Only Apply to Clearing Agencies that Provide Central Securities Depository ("CSD") Services**	
17Ad-22 (d)(11): Default procedures	O	O	O
17Ad-22 (d)(12): Timing of settlement finality	O	O	
17Ad-22 (d)(13): Delivery versus payment	O	O	
17Ad-22 (d)(14): Controls to address participants' failure to settle		**Would Only Apply to Clearing Agencies that Provide CSD Services**	
17Ad-22 (d)(15): Physical delivery risks	O	O	
17Aj-1: Dissemination of pricing and valuation information	**Would Only Apply to Clearing Agencies that Provide CCP Services for SBS**		
17Ad-23: Policies and procedures to protect confidentiality of trading information of participants	O	O	O
Amendments to Rule 17Ab2-1: Registration of clearing agencies	O	O	O
17Ad-25: Procedures to identify and address conflicts of interests	O	O	O
17Ad-26: Standards for board or board committee directors	O	O	O
3Cj-1: Designation of chief compliance officer	O	O	O

A. Proposed Rule 17Ad-22 Standards for all Clearing Agencies

The Commission is proposing Rule 17Ad-22 to augment the statutory requirements under the Exchange Act by establishing minimum requirements regarding how clearing agencies must maintain effective risk management procedures and controls as well as meet the statutory requirements under the Exchange Act on an ongoing basis. For a clearing agency to be registered under Section 17A, it must have the ability to facilitate the prompt and accurate clearance and settlement of transactions, safeguard investor funds and securities, remove impediments to and perfect the mechanism of a national clearance and settlement system, and generally protect investors.[25] Also, the clearing agency's rules must provide adequate access to qualified participants, fair representation of shareholders and participants, equitable pricing, fair discipline of participants, and must not impose any undue burden on competition.[26] Section 17A of the Exchange Act explicitly provides the Commission with discretion to update the rules for clearing agencies consistent with the Exchange Act.[27] Further, Section 805(a) of the Dodd-Frank Act directs the Commission to take into consideration relevant international standards and existing prudential requirements for clearing agencies that are designated as FMUs.[28] The current international standards most relevant to risk management of clearing agencies are the standards developed by the Technical Committee of the International Organization of Securities Commissions ("IOSCO") and the Committee on Payment and Settlement Systems ("CPSS") of the Bank for International Settlements that are contained in the following reports: Recommendations for Securities Settlement Systems (2001) ("RSSS"), and Recommendations for Central Counterparties (2004) ("RCCP") (collectively "CPSS-IOSCO Recommendations").[29]

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25 See 15 U.S.C. 78q-1.

26 See id.

27 See id.

28 12 U.S.C. 5464(a)(1).

29 The complete RSSS and RCCP Reports are available on the website of the Bank for International Settlements at http://www.bis.org/publ/cpss46.htm and http://www.bis.org/publ/cpss64.htm respectively.

The RSSS and RCCP Reports were drafted by IOSCO and CPSS ("Task Force"). The Task Force consisted of securities regulators and central bankers from 19 countries (i.e., The Commission preliminarily believes that certain aspects of the CPSS-IOSCO Recommendations should be made to clearly apply to clearing agencies and that such application would further the objectives and principles for clearing agencies under the Exchange Act and the Dodd-Frank Act, including those that are related to sound risk management practices and to fair and open access. These international standards were formulated by securities regulators and central banks to promote sound risk-management practices and encourage the safe design and operation of entities that provide clearance and settlement services. The Commission is proposing Rule 17Ad-22 (which is consistent with the CPSS-IOSCO Recommendations but reflects modifications designed to tailor the proposed rule to the Exchange Act and the U.S. clearance and settlement system) because the Commission preliminarily believes that the rule would help to facilitate prompt and accurate clearance and settlement, safeguard securities and funds and protect investors.[30]

The Commission preliminarily believes that the adoption of proposed Rule 17Ad-22, which is based on the CPSS-IOSCO Recommendations, and the application of this rule to all clearing agencies would have several important benefits, including providing a robust framework for assessing and addressing the risks within clearing agencies. The Commission requests comment on proposed Rule 17Ad-22 and the consideration of the CPSS-IOSCO

Australia, Belgium, Brazil, China, Czech Republic, France, Germany, Hong Kong, India, Italy, Japan, Malaysia, Mexico, The Netherlands, Saudi Arabia, Singapore, Spain, England, and the United States) and the European Union. The U.S. representatives on the Task Force included staff from the Commission, the Federal Reserve, and the CFTC. The Federal Reserve has incorporated the RSSS and RCCP, as well as the Core Principles for Systemically Important Payment Systems, in its Federal Reserve Policy on Payment System Risk. The Federal Reserve applies these standards in its supervisory process and expects systemically important systems, as determined by the Federal Reserve and subject to its authority, will complete a self-assessment against the standards set forth in the policy. See Policy on Payment System Risk, 72 FR 2518 (January 12, 2007).

30 See 15 U.S.C. 78q-1(d).

Recommendations in connection with the proposed rule. The Commission also requests comment on whether the proposed rules are properly tailored to assess and address the risks at clearing agencies and whether they are sufficiently clear to enable clearing agencies to reasonably determine whether they are in compliance with the rules or whether the Commission should provide additional guidance.[31]

The Commission notes that IOSCO and the CPSS are currently in the process of revising their existing sets of international standards.[32] This review is intended to strengthen and clarify the CPSS-IOSCO Recommendations, as well as the CPSS's existing standards for payment systems entitled: Core Principles for Systemically Important Payment Systems. The Commission may, as international standards evolve, consider additional modifications to its rules as the Commission determines is appropriate based on its own experience and the requirements under the Exchange Act.

Proposed Rule 17Ad-22 contains certain additional requirements that are not addressed or contemplated by international standards. For clearing agencies that perform CCP services, these additional requirements are found in the following proposed rules: (1) Rule 17Ad-22(b)(3), which would require heightened financial resources for clearing agencies that provide CCP services for securities that are security-based swaps; (2) Rule 17Ad-22(b)(5), which would prohibit membership restrictions based on dealer status; (3) Rule 17Ad-22(b)(6), which would

31 Several clearing agencies have published their evaluations of their compliance with the CPSS-IOSCO Recommendations on their websites. See http://www.dtcc.com/legal/compliance/assessments.php. In addition, several clearing agencies, as part of requests for the CDS Clearing Exemption Orders, have represented to the Commission that they met the standards set forth in the RCCP. See supra note 6.

32 In December 2009, IOSCO and CPSS began a comprehensive review of existing standards for FMUs, which includes the RSSS and RCCP. This review intends to strengthen and clarify the standards based on experience with the standards since their publication and specifically from lessons learned during the recent financial crisis.

prohibit membership restrictions based on minimum volume and transaction thresholds; (4) Rule 17Ad-22(b)(7), which would prohibit restrictions on clearing agency membership based on minimum net capital requirements of $50 million or more; and (5) Rule 17Ad-22(c)(1), which would require calculation and maintenance of records of the clearing agency's financial resources.[33]

In addition, the Commission is proposing additional rules for all clearing agencies (whether or not they offer CCP services) that are not addressed or contemplated by the international standards. These proposed rules would: (1) require dissemination of pricing and valuation information by security-based swap clearing agencies that perform CCP services (Proposed Rule 17Aj-1); (2) require all clearing agencies to have adequate safeguards and procedures to protect the confidentiality of trading information of clearing agency participants (Proposed Rule 17Ad-23); (3) exempt certain security-based swap dealers and security-based swap execution facilities from the definition of a clearing agency (Proposed Rule 17Ad-24); (4) amend rules concerning registration of clearing agencies to account for security-based swap clearing agencies and to make other technical changes (Rule 17Ab2-1); (5) require all clearing agencies to have procedures that identify and address conflicts of interest (Proposed Rule 17A-25); (6) require clearing agencies to set standards for all members of their boards of directors or committees (Proposed Rule 17Ad-26); and (7) require all clearing agencies to designate a chief compliance officer (Proposed Rule 3Cj-1).

1. Proposed Rule 17Ad-22(a)

Proposed Rule 17Ad-22(a) contains five definitions. Proposed Rule 17Ad-22(a)(1) would define CCP as a clearing agency that interposes itself between counterparties to securities

33 Proposed Rule 17Ad-22(c)(2) would apply to all clearing agencies and require them to post annual audited financial reports on their websites.

transactions to act functionally as the buyer to every seller and as the seller to every buyer. Proposed Rule 17Ad-22(a)(2) would define "central securities depository services" to mean services of a clearing agency that is a securities depository as described in Section 3(a)(23) of the Exchange Act.[34] Proposed Rule 17Ad-22(a)(3) would define "participant", for the limited purposes of proposed Rules 17Ad-22(b)(3) and 17Ad-22(d)(14), to mean that if a participant controls another participant, or is under common control with another participant, then the affiliated participants shall be collectively deemed to be a single participant. Proposed Rule 17Ad-22(a)(4) would define "normal market conditions", for the limited purposes of proposed Rules 17Ad-22(b)(1) and (2), to mean conditions in which the expected movement of the price of cleared securities would produce changes in a clearing agency's exposures to its participants that would be expected to breach margin requirements or other risk control mechanisms only one percent of the time. Proposed Rule 17Ad-22(a)(5) would define "net capital", for the limited purposes of proposed Rule 17Ad-22(b)(7), to have the same meaning as set forth in Rule 15c3-1 under the Exchange Act for broker-dealers or any similar risk adjusted capital calculation for all other prospective clearing members.[35]

The Commission preliminarily believes that these five proposed definitions would be consistent with the common meaning of these terms as understood in the clearance and settlement industry. In addition, the Commission preliminarily believes the definition of "normal

34 [Clearing agency] also means any person, such as a securities depository, who (i) acts as a custodian of securities in connection with a system for the central handling of securities whereby all securities of a particular class or series of any issuer deposited within the system are treated as fungible and may be transferred, loaned, or pledged by bookkeeping entry without physical delivery of securities certificates, or (ii) otherwise permits or facilitates the settlement of securities transactions or the hypothecation or lending of securities without physical delivery of securities certificates. 15 U.S.C. 78c(a)(23).

35 As appropriate, the clearing agency would develop risk adjusted capital calculations for prospective clearing members that are not broker-dealers.

market conditions" would be consistent with international use of that term in the context of clearing agency risk management.[36] The Commission intends for these definitions to provide clearing agencies with appropriate guidance to determine when requirements under proposed Rule 17Ad-22 would apply. The Commission requests comment on the proposed definitions, including whether any additional clarification would be helpful.

2. Proposed Rule 17Ad-22(b)

Proposed Rule 17Ad-22(b) would set forth standards that are applicable to clearing agencies that provide CCP services. Specifically, the proposed rule would provide standards with respect to measurement and management of credit exposures, margin requirements, financial resources, and annual evaluations of the performance of the clearing agency's margin models. The proposed rule would also require membership access to clearing agencies for persons that are not dealers or security-based swap dealers, prohibit the use of minimum portfolio size and minimum volume transaction thresholds as a condition for membership at a clearing agency, and permit membership access to a clearing agency by persons with net capital equal to or greater than $50 million. The discussion below provides greater detail regarding each respective standard covered in proposed Rule 17Ad-22(b). The proposed rule is designed to address risks and participant membership structures that are specifically linked to the provision of services associated with a clearing agency interposing itself between counterparties to securities transactions and acting functionally as the buyer to every seller and the seller to every buyer (i.e., CCP services). Accordingly, the Commission preliminarily believes that these

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36 In the context of the RCCP, "normal market conditions" means conditions in which the expected movement of the price of cleared securities would produce changes in a clearing agency's exposures to its participants that would be expected to breach margin requirements or other risk control mechanisms only one percent of the time. See CPSS Publications Recommendations for Central Counterparties, (November 2004), available at http://www.bis.org/publ/cpss64.htm.

requirements would not need to apply to clearing agencies that do not provide CCP services because they would not be engaged in activities that the proposed rule is designed to address.

The Commission preliminarily believes that proposed Rule 17Ad-22(b) would provide standards designed to help ensure sound risk management practices at clearing agencies providing CCP services. Further, the Commission preliminarily believes that the requirements of proposed Rule 17Ad-22(b) would help ensure that the rules, policies and procedures of a clearing agency providing CCP services will be designed to promote fair and open access, to promote the prompt and accurate clearance and settlement of securities transactions, and to assure the safeguarding of securities and funds that are in the custody or control of the clearing agency or for which it is responsible.

Proposed Rule 17Ad-22(b)(1): Measurement and Management of Credit Exposures

Proposed Rule 17Ad-22(b)(1) would require a clearing agency that provides CCP services to establish, implement, maintain and enforce written policies and procedures reasonably designed to measure its credit exposures to its participants at least once each day, and limit its exposures to potential losses from defaults by its participants in normal market conditions[37] so that the operations of the clearing agency would not be disrupted and non-defaulting participants would not be exposed to losses that they cannot anticipate or control.

The Commission preliminarily believes that measurement and management of credit exposures can, among other things, reduce the likelihood in a participant default scenario that losses from default would disrupt the operations of the clearing agency and its non-defaulting participants and adversely affect the functioning of the clearing agency. A clearing agency providing CCP services faces the risk that its exposures to participants can change dramatically

[37] See supra note 36.

as a result of changes in prices, in positions, or both. Adverse price movements can rapidly increase exposures to participants, and participants may rapidly change or concentrate their positions through new trading. If not appropriately measured and managed, such results could lead to significant liabilities accruing at the clearing agency.

Recognizing that the risks that clearing agencies are likely to face will change over time, the Commission is proposing that a clearing agency providing CCP services be required to measure its credit exposures to its participants at least once each day. The Commission preliminarily believes this is the minimum frequency of measurement that would permit a clearing agency to effectively consider the risks it faces because of the potential for significant changes to the risk profiles of its participants to change on a daily basis.

In addition to requiring clearing agencies to take steps to measure their credit exposures to participants, the proposed rule would also require clearing agencies to limit their exposures to potential losses from participant defaults. By collecting sufficient margin and having other resources in place to account for losses arising under normal market conditions, the Commission expects that a clearing agency would be able to limit its exposures to potential losses from defaults by its participants. The Commission preliminarily believes that the proposed rule should thereby help ensure prompt and accurate clearance and settlement.

Request for Comment

The Commission generally requests comments on all aspects of proposed Rule 17Ad-22(b)(1). In addition, the Commission requests comments on the following specific issues:

- Is the Commission's proposed rule regarding measurement and management of credit exposures sufficiently clear? If not, why not and what would be a better alternative?

- How do current practices of clearing agencies providing CCP services with respect to measurement and management of credit exposures compare to the practices that the Commission proposes to require in this rule? What are the expected incremental costs to clearing agencies providing CCP services in connection with adding to or revising their current practices in order to implement the Commission's proposed rule?
- Should the Commission require clearing agencies acting as CCPs to use any specific confidence level for limiting potential losses under the proposed rule when clearing certain products, or to use minimum amounts of market data when calculating credit exposures? Why or why not?
- What level of discretion should the Commission allow clearing agencies providing CCP services to exercise when measuring and managing credit exposure? Are there circumstances when such discretion should be limited?
- Is it more difficult for clearing agencies providing CCP services and their participants to anticipate and control losses associated with certain types of financial products compared to others? If so, how should the Commission take this into account when establishing rules for clearing agency standards? For example, should the Commission require additional risk management measures to be applied by clearing agencies providing CCP services when judging the risks associated with financial products that trade infrequently or when valuation models for the product are not yet broadly accepted in the financial market? Why or why not?
- Extremely illiquid security-based swap products may be difficult to clear under a conventional CCP clearing model because it may be difficult to value them with a

degree of accuracy that allows the CCP to properly manage the risk of those positions. Should the Commission explore developing alternatives to the requirements contained in proposed Rule 17Ad-22(b)(1) based on the liquidity of products a clearing agency clears? What effect would any such requirements have on the potential development of alternative clearing models for highly-illiquid products that would convey some of the benefits of clearing (such as centralized holding of collateral by a third-party custodian, daily adjustment of variation margin amounts, daily posting and return of variation margin, independent valuation of positions, and prompt close-out of positions held by a defaulting market participant)?

- Should the Commission consider requiring clearing agencies that provide CCP services to measure exposures to participants more or less frequently than a minimum of once daily?

Proposed Rule 17Ad-22(b)(2): Margin Requirements

Proposed Rule 17Ad-22(b)(2) would require a clearing agency that provides CCP services to establish, implement, maintain and enforce written policies and procedures reasonably designed to: (i) use margin requirements to limit its credit exposures to participants in normal market conditions;[38] (ii) use risk-based models and parameters to set margin requirements; and (iii) review the models and parameters at least monthly.

The Commission preliminarily believes that use of margin requirements by clearing agencies providing CCP services to collect assets (e.g., cash or securities) from its participants as a way to limit exposures to participants in normal market conditions would, among other things, provide the clearing agency with assets it could readily use to limit losses incurred by a

[38] See supra note 36.

participant in the event of a default. By limiting its credit exposure in this manner, a clearing agency providing CCP services would be less likely to be subject to disruptions in its operations as a result of a participant default, thereby promoting prompt and accurate clearance and settlement.

The Commission also preliminarily believes that risk-based models and parameters should be used to set margin requirements because they permit a clearing agency providing CCP services to tailor the amount of margin collected to the needs of the clearing agency. Specifically, models and parameters for collecting margin that account for the risks the clearing agency providing CCP services faces when transacting with a participant may be more likely to result in effective and efficient margin requirements because the level of margin collected would be commensurate with the level of risk presented by the participant to the clearing agency.

In addition, the Commission preliminarily believes that the review of these models and parameters should be required to occur at least monthly. Market conditions and risks are constantly changing and therefore the models and parameters used by a clearing agency providing CCP services to set margin may not accurately reflect the needs of a clearing agency if they are permitted to remain static. The Commission recognizes, however, that there may be benefits to maintaining some stability with respect to margin levels in order to limit operational difficulties. Accordingly, the Commission is proposing that clearing agencies providing CCP services be required to review their models and parameters at least monthly because the Commission preliminarily believes that such time frame would limit the potential that such parameters or models will become stale while also providing the clearing agency flexibility to maintain some stability with respect to determinations for margin requirements.

<u>Request for Comment</u>

The Commission generally requests comments on all aspects of proposed Rule 17Ad-22(b)(2). In addition, the Commission requests comments on the following specific issues:

- Is the Commission's proposed rule regarding margin requirements sufficiently clear? If not, why not and what would be a better alternative?
- How do current practices of clearing agencies regarding margin requirements compare to the practices that the Commission proposes to require in this rule? What are the expected incremental costs to clearing agencies in connection with adding to or revising their current practices in order to implement the Commission's proposed rule?
- Should the Commission require clearing agencies providing CCP services to impose any special margin or intraday margin requirements in certain circumstances? Are there circumstances when special margin or intraday margining would not be appropriate? Why or why not?
- Should the Commission allow clearing agencies providing CCP services to exercise significant discretion when establishing margin practices? Why or why not? Are there circumstances when such discretion should be limited? Is there a risk that clearing agencies providing CCP services may lower margin standards to compete for business? If so, how should the Commission take such factors into account when establishing rules for clearing agencies providing CCP services?
- Should the Commission consider requiring a clearing agency that provides CCP services to review its margin model and parameters more or less frequently than at least monthly?

Proposed Rule 17Ad-22(b)(3): Financial Resources

Proposed Rule 17Ad-22(b)(3) would require a clearing agency that provides CCP services to establish, implement, maintain and enforce written policies and procedures reasonably designed to maintain sufficient financial resources to withstand, at a minimum, a default by the participant to which it has the largest exposure in extreme but plausible market conditions, provided that a security-based swap clearing agency shall maintain sufficient financial resources to withstand, at a minimum, a default by the two participants to which it has the largest exposures in extreme but plausible market conditions.[39]

The Commission preliminarily believes that requiring a clearing agency, other than a security-based swap clearing agency, that provides CCP services to maintain sufficient financial resources to withstand, at a minimum, a default by the participant to which it has the largest exposure in extreme but plausible market conditions would, among other things, reduce the likelihood that a default would create losses that would disrupt the operations of the clearing agency and adversely affect the clearing agency's non-defaulting participants. However, the Commission preliminarily believes that security-based swap clearing agencies that provide CCP services face additional risk-management challenges because of factors unique to the security-based swaps market, such as more limited historical information on pricing and the jump-to-default risk[40] associated with certain security-based swaps, such as CDS. The Commission

39 See proposed Rule 17Ad-22(a)(3), supra Section II.A.1 (defining "participant" for purposes of proposed Rule 17Ad-22(b)(3)).

40 Jump-to-default risk relates to the possibility of a reference entity unexpectedly experiencing a credit event over a short period resulting in significant changes in the value of any CDS contracts written on that particular reference entity. For example, a seller of a CDS could be collecting regular premiums with little expectation that the reference entity may default. However, if that reference entity suddenly experiences a credit event, it will trigger an unexpected obligation on the protection seller to pay a lump sum, dependent on the size of the contract, to the protection buyer. See generally Darrell Duffie and Haoxiang Zhu, Does a Central Clearing Counterparty Reduce Counterparty

preliminarily believes that to promote prompt and accurate clearance and settlement and maintain higher levels of financial resources to account for these risks, it is important for security-based swap clearing agencies that provide CCP services to be able to withstand a default by the two participants to which the clearing agency has its largest exposures in extreme but plausible market conditions. Moreover, the Commission expects that when a clearing agency that provides CCP services determines what level of financial resources would be sufficient to account for exposures in extreme but plausible market conditions, the clearing agency would consider potential losses that would be greater than those resulting from observed periods of significant volatility or disturbances.

Request for Comment

The Commission generally requests comments on all aspects of proposed Rule 17Ad-22(b)(3). In addition, the Commission requests comments on the following specific issues:

- Is the Commission's proposed rule regarding requiring clearing agencies providing CCP services to maintain sufficient financial resources sufficiently clear? If not, why not and what would be a better alternative?
- Should the Commission require all clearing agencies providing CCP services, instead of only those clearing security-based swaps, to maintain sufficient financial resources to withstand a default by the two participants to which it has the largest exposures in extreme but plausible market conditions? Should all or any subset of clearing agencies be required to maintain sufficient financial resources based on more or less

Risk? (Stanford Univ. 2010), available at http://www.stanford.edu/~duffie/DuffieZhu.pdf.

than two participant defaults? For example, should the financial resources requirements be different for certain clearing agencies, such as security-based swap clearing agencies or those designated as systemically important under the Clearing Supervision Act? Should the Commission require that financial resources be measured based on a different standard than resources needed to withstand default by a certain number of participants, such as a percentage of the total business conducted by the clearing agency?

- How do current practices of clearing agencies pertaining to financial resources compare to the practices that the Commission proposes to require in this rule? What are the expected incremental costs to clearing agencies in connection with adding to or revising their current practices in order to implement the Commission's proposed rule?
- Are the financial resources standards for clearing agencies providing CCP services proposed by the Commission sufficient for the proper functioning of a clearing agency? Should a clearing agency providing CCP services be able to mutualize losses during a default using financial resources designed to cover price movements? Should the Commission establish more specific rules? For example, should the Commission establish standards for the level of clearing agency resources maintained in a guarantee fund as opposed to a margin fund, or should clearing agencies providing CCP services be given discretion to manage the composition of their financial resources as they see fit? Why or why not? Should the Commission establish more prescriptive requirements concerning the financial resources of certain clearing agencies providing CCP services, such as those that clear security-based

swaps or those that are designated as systemically important under the Clearing Supervision Act?

- Should the Commission provide additional guidance regarding what constitutes "extreme but plausible market conditions"? Does allowing clearing agencies providing CCP services discretion to interpret this term create uncertainty or introduce more risk into the financial system than might otherwise be the case?
- What are clearing agencies' providing CCP services and their participants' incentives to maintain financial resources to withstand the foreseeable consequences of participant defaults? Are there identifiable circumstances in which these self-interested incentives may vary? For example, do clearing agencies providing CCP services with public shareholders have different incentives than clearing agencies providing CCP services that are member-owned? Can the capital structure of the clearing agency providing CCP services and the order in which losses are suffered by defaulting parties, surviving participants and any public shareholders affect the level of risk accepted by the clearing agency? If so, how should the Commission take these factors into account when establishing rules for clearing agencies providing CCP services?

Proposed Rule 17Ad-22(b)(4): Model Validation

Proposed Rule 17Ad-22(b)(4) would require a clearing agency that provides CCP services to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide for an annual model validation process consisting of evaluating the performance of the clearing agency's margin models and the related parameters and assumptions associated with such models by a qualified person who does not perform functions associated with the clearing agency's margin models (except as part of the annual model validation) and does not report to a person who performs these functions.[41]

The Commission preliminarily believes that clearing agencies that provide CCP services need to have a qualified person conduct a review of models that are used to set margin levels, along with related parameters and assumptions, in order to assure that the models perform in a manner that facilitates prompt and accurate clearance and settlement of transactions. In determining whether a person is qualified to conduct the model validation, clearing agencies providing CCP services could consider several factors, including the person's experience in validating margin models, expertise in risk management generally, and understanding of the clearing agency's operations and procedures.

In addition, the Commission is proposing that the person conducting the model validation be a person who does not perform functions associated with the clearing agency's margin models (except as part of the annual model validation) and does not report to a person who performs these functions. The Commission preliminarily believes that a review by a person who is not involved in the day-to-day operation of the margin model is important to identify potential vulnerabilities or limitations and to promote a critical evaluation of the model. This is because a person involved in the functions related to the model's operation, or someone who reports to such a person, may be less likely to critically evaluate the margin model because of preconceived views or a desire not to find issues with a model that they help to operate.[42] The Commission

41 Any person responsible for supervising the operation of the clearing agency's margin model would be viewed as performing the functions associated with the clearing agency's margin model and could not therefore have supervisory authority over the person conducting the model validation.

42 Proposed Rule 17Ad-22(b)(4), however, would not prevent a person conducting the model validation from being employed by the clearing agency if the conditions in the proposed rule are satisfied. For example, a qualified member of the internal audit

preliminarily believes that the person validating the clearing agency's margin model should be sufficiently free from outside influences so that he or she can be completely candid in their assessment of the model.

Finally, the Commission is proposing that the model validation be conducted on an annual basis. The Commission preliminarily believes that conducting the model validation on an annual basis would provide a sufficiently frequent evaluation period because model performance ordinarily would not be expected to vary significantly over short periods but should be re-evaluated as market conditions change.

Request for Comment

The Commission generally requests comments on all aspects of proposed Rule 17Ad-22(b)(4). In addition, the Commission requests comments on the following specific issues:

- Is the Commission's proposed rule requiring clearing agencies to provide for a model validation sufficiently clear? If not, why not and what would be a better alternative?
- What are the advantages and disadvantages of requiring an annual model validation? Should a more or less frequent model validation be required? Should the model validation be specifically triggered as a result of any material change in the clearing agency, such as the introduction of new products or the addition of portfolio margining arrangements with other clearing agencies?
- Should the Commission place more or less stringent restrictions on the type of person who is permitted to conduct the model validation? For example, should the Commission prescribe any specific qualifications that the person conducting the model validation should have? Should the Commission require an outside consultant

function that operates under a separate reporting line may be able to provide the model validation.

be engaged to conduct the model validation? Should persons that perform functions associated with the clearing agency's margin model be able to conduct the model validation?

- Does the proposal provide sufficient or excessive separation of the person conducting the model validation from the persons who develop and administer the model? In either case, please explain. Should the Commission adopt additional requirements to help ensure that the persons conducting the model validation are free from retaliation and influence? If so, please explain. What costs or burdens might such additional requirements impose on the effective validation of models?

Proposed Rule 17Ad-22(b)(5): Non-Dealer Member Access

Proposed Rule 17Ad-22(b)(5) requires a clearing agency that provides CCP services to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide the opportunity for a person that does not perform any dealer[43] or security-based swap dealer[44] services to obtain membership on fair and reasonable terms at the clearing agency in order to clear securities for itself or on behalf of other persons. Dealer and security-based swap

[43] The term "dealer" is defined in Section 3(a)(5) of the Exchange Act and means any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise. The definition contains an exception for a person that buys or sells securities for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business. There is also an exception for banks engaging in certain specified activities. See 15 U.S.C. 78c(a)(5) for the complete definition.

[44] Pursuant to Section 761 of the Dodd-Frank Act, the term "security-based swap dealer" is added as Section 3(a)(71) of the Exchange Act, 15 U.S.C 78c(a), and generally means any person who (A) holds itself out as a dealer in security-based swaps; (B) makes a market in security-based swaps; (C) regularly enters into security-based swaps with counterparties as an ordinary course of business for its own account; or (D) engages in any activity causing it to be commonly known in the trade as a dealer or market maker in security-based swaps. See Pub. L. No. 111-203, Section 761 for the complete definition. See also Exchange Act Release No. 63452 (December 7, 2010), 75 FR 80174 (December 21, 2010), supra note 4.

dealer services generally involve services designed to facilitate securities transactions by buying and selling securities for a person's own account. The Commission preliminarily believes that requiring clearing agencies that perform CCP services to allow persons who are not dealers or security-based swap dealers to become members of the clearing agency will promote more competition in and access to clearing through facilitating indirect clearing arrangements, commonly referred to as correspondent clearing. Correspondent clearing is an arrangement between a current participant of a clearing agency and a non-participant that desires to use the clearing agency for clearance and settlement services.

The Commission has previously noted that in situations where direct access to clearing agencies is limited by reasonable participation standards firms that do not meet these standards may still be able to access clearing agencies through correspondent clearing arrangements with direct participants.[45] Such a process would involve the non-participant entering into a correspondent clearing arrangement with a participant so that the transaction may be submitted by the participant to the clearing agency. Thus, the success of correspondent clearing arrangements depends on the willingness of participants to enter into such arrangements with non-participant firms which may act as direct competitors to the participants in the participants' capacity as dealers or security-based swap dealers in the market for buying or selling the relevant securities. Given that participants that are dealers or security-based swap dealers may have an incentive to restrict clearing access to potential competitors, correspondent clearing arrangements may not be readily established without providing participants that do not provide dealer or security-based swap dealer services with the ability to become members of a clearing

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[45] See Exchange Act Release No. 63107 (October 14, 2010), 75 FR 65882 (October 26, 2010) (Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps under Regulation MC).

agency and thereby help develop correspondent clearing arrangements..

At the same time, the Commission recognizes that persons who are not dealers or security-based swap dealers may fail to meet other standards for membership at a clearing agency, such as the operational capabilities required for direct participation. Proposed Rule 17Ad-22(b)(5) would not prohibit clearing agencies that provide CCP services from taking these factors into account when establishing membership criteria for non-dealers. Rather, the proposal would prohibit clearing agencies that provide CCP services from denying membership on fair and reasonable terms to otherwise qualified persons solely by virtue of the fact that they do not perform any dealer or security-based swap dealer services.

The Commission preliminarily believes that the incentives of persons who do not provide dealer or security-based swap dealer services to promote access at the clearing agency that provides CCP services would not be limited by a desire to restrict competition in the market for buying or selling the relevant securities. Accordingly, the Commission preliminarily believes that permitting such persons to become members of a clearing agency that provides CCP services may foster the development of correspondent clearing arrangements that would allow dealers and security-based swap dealers, who may otherwise not be able to meet reasonable participation standards of a clearing agency, to obtain access to the clearing agency through correspondent clearing arrangements. The Commission preliminarily believes this would be beneficial because it could result in greater competition in and access to clearing.

Request for Comment

The Commission generally requests comments on all aspects of proposed Rule 17Ad-22(b)(5). In addition, the Commission requests comments on the following specific issues:

- In addition to prohibiting denial of membership based on whether a person provides dealer or security-based swap dealer services as a way to facilitate greater indirect access to clearing, should the Commission consider other measures to promote access to clearing at clearing agencies that provide CCP services, including any requirements designed to promote greater direct access to clearing (e.g., adding specific membership categories)?
- Should clearing agencies that provide CCP services be required to have policies and procedures that are designed to promote membership by non-dealers? If so, what would be the advantages and disadvantages of requiring the clearing agency to periodically measure its performance against the objectives contained in such policies and procedures, and who within the clearing agency should be responsible for conducting such a review (for instance the chief compliance officer)?
- Is the Commission's proposed rule requiring clearing agencies that provide CCP services to provide the opportunity for a person that does not perform any dealer or security-based swap dealer services to obtain membership at the clearing agency to clear securities for itself or on behalf of other persons sufficiently clear? If not, why not?
- Should the Commission consider more prescriptive regulations to specify the criteria that clearing agencies should use to grant membership privileges to persons that do not perform any dealer or security-based swap dealer services to clear securities for themselves or on behalf of other persons? Please explain why or why not.

- What are the potential advantages and disadvantages of having persons that do not provide dealer or security-based swap dealer services as members of a clearing agency?
- If a clearing agency that provides CCP services does not have rules that facilitate correspondent clearing, should the Commission consider requiring that clearing agency to justify to the Commission why its rules do not facilitate correspondent clearing? What would be the advantages and disadvantages of such a requirement? What are the potential reasons why a clearing agency may not have rules that facilitate correspondent clearing arrangements?
- Should the Commission consider limiting the proposed requirement for providing membership access to persons who do not provide dealer or security-based swap dealer services to a certain category of clearing agencies, such as security-based swap clearing agencies that provide CCP services or those designated as systemically important? Please explain why or why not. In particular, are there special considerations, such as market concentration, affecting security-based swap clearing agencies that provide CCP services that make access to those clearing agencies for non-dealers particularly important? If not, why not? If so, what are those considerations and how would this requirement address them? Do any similar considerations exist, or is there a potential that similar considerations could exist in the future, with respect to clearing agencies that clear securities other than security-based swaps? Would there be any advantages or disadvantages to maintaining one standard for all clearing agencies that provide CCP services? Please explain.

<u>Proposed Rule 17Ad-22(b)(6): Portfolio Size and Transaction Volume Thresholds Restrictions</u>

Proposed Rule 17Ad-22(b)(6) prohibits a clearing agency that provides CCP services from having membership standards that require that participants maintain a portfolio of any minimum size or that participants maintain a minimum transaction volume. The Commission notes that the proposed rule would not prohibit a clearing agency that provides CCP services from considering portfolio size and transaction volume as one of several factors when reviewing a potential participant's operations. Rather, the proposed rule would prohibit the establishment of minimum portfolio sizes or transaction volumes that by themselves would act as barriers to participation by new participants in clearing. Such minimum thresholds would not function as a good indicator of whether a participant is able to meet its obligations to a clearing agency.[46] This is because new participants to a clearing agency that provides CCP services that do not initially intend to transact in substantial size or volume may nevertheless have the operational and financial capacity to perform the activities that other participants are able to perform. Therefore, the Commission preliminarily believes that the proposed rule may help to facilitate the requirement in Section 17A of the Exchange Act that the rules of a clearing agency permit fair and open access.[47]

Request for Comment

The Commission generally requests comments on all aspects of proposed Rule 17Ad-22(b)(6). In addition, the Commission requests comments on the following specific issues:

- Is the Commission's proposed rule prohibiting clearing agencies that provide CCP services from having membership standards that require participants to maintain a

46 Proposed Rule 17Ad-22(b)(6) would not prohibit a clearing agency from imposing maximums portfolio sizes or transaction volume amounts.

47 See infra note 59.

portfolio of any minimum size or to meet a minimum transaction volume threshold sufficiently clear? If not, why not?

- What are the potential advantages and disadvantages of prohibiting clearing agency membership standards from requiring participants to maintain a minimum portfolio size or meet a minimum transaction volume threshold? Please explain.
- Should the Commission consider imposing the proposed requirements on all clearing agencies, rather than only those that provide CCP services? Why or why not?
- Should the Commission consider prohibiting only security-based swap clearing agencies that provide CCP services from having membership standards that require participants to maintain a minimum portfolio size or to maintain a minimum transaction volume? Please explain why or why not. In particular, are there special considerations affecting security-based swap clearing agencies that provide CCP services that make it particularly important to prevent use of these specific criteria in their membership standards? If so, what are those special considerations and how would this requirement address them? If not, in what ways would such a requirement impact the operations of security-based swap clearing agencies that provide CCP services and other types of clearing agencies? Would there be advantages to maintaining one standard for all clearing agencies that provide CCP services? Why or why not?

<u>Proposed Rule 17Ad-22(b)(7): Net Capital Restrictions</u>

Proposed Rule 17Ad-22(b)(7) requires a clearing agency that provides CCP services to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide a person that maintains net capital[48] equal to or greater than $50 million with the opportunity to obtain membership at the clearing agency, with any net capital requirements being scalable so that they are proportional to the risks posed by the participant's activities to the clearing agency. This means that while a clearing agency that provides CCP services could not restrict access to the clearing agency solely because a participant does not have a net capital level above $50 million, the clearing agency's policies and procedures could be reasonably designed to limit the activities of the participant in comparison to the activities of other participants that maintained a higher net capital level. For example, as a way to help make its requirements scalable, a clearing agency may elect to place limits on its potential exposure to participants operating at certain net capital thresholds by restricting the maximum size of the portfolio such participants are permitted to maintain at the clearing agency. The Commission preliminarily believes that persons that maintain a net capital level of $50 million would have sufficient net capital to be able to participate at some level in a clearing agency that provides CCP services, provided that they are able to comply with other reasonable membership standards. Based on broker-dealer reporting data available to the Commission, the $50 million threshold for net capital is a standard that only approximately 4% of the total number of broker-dealers could satisfy. Accordingly, the Commission preliminarily believes that prohibitions on membership access that are based solely on persons having net capital equal to or greater than $50 million could introduce unnecessary barriers to clearing access. The Commission also preliminarily believes that the proposed rule would facilitate sound risk management practices by the clearing

48 Proposed Rule 17Ad-22(a)(5) would define "net capital", for the limited purposes of proposed Rule 17Ad-22(b)(7), to have the same meaning as set forth in Rule 15c3-1 under the Exchange Act for broker-dealers or any similar risk adjusted capital calculation for all of other prospective clearing members.

agencies by encouraging the clearing agencies to examine and articulate the benefits of higher net capital requirements as a result of having clearing agencies develop scalable membership standards that link the nature and degree of participation with the potential risks posed by the participant.[49]

Proposed Rule 17Ad-22(b)(7) also permits a clearing agency to provide for a higher net capital requirement (i.e., higher than $50 million) as a condition for membership at the clearing agency if the clearing agency demonstrates to the Commission that such a requirement is necessary to mitigate risks that could not otherwise be effectively managed by other measures, such as scalable limitations on the transactions that the participants may clear through the clearing agency, and the Commission approves the higher net capital requirement as part of a rule filing or clearing agency registration application. The Commission preliminarily believes that by providing a method for clearing agencies to impose higher net capital requirements in circumstances where such requirements are necessary to mitigate risks, the proposed rule would provide appropriate flexibility for risk management purposes.

Request for Comment

The Commission generally requests comments on all aspects of proposed Rule 17Ad-22(b)(7). In addition, the Commission requests comments on the following specific issues:

- Is the Commission's proposed rule limiting the ability of clearing agencies that provide CCP services to deny membership access to participants with $50 million or more in net capital sufficiently clear? If not, why not?

49 The Commission notes there are examples of capital-related requirements that differentiate among types of participants. For instance, the Fixed Income Clearing Corporation has maintained a $50 million net worth requirement and $10 million excess net capital requirement for its Category 1 Dealer Netting Members and a $25 million net worth requirement and $10 million excess net capital requirement for its Category 2 Dealer Netting Members.

- What are advantages or disadvantages of requiring a clearing agency that provides CCP services to provide a person that maintains a net capital equal to or greater than $50 million with the ability to obtain membership at the clearing agency, with any net capital requirements being scalable so that they are proportional to the risks posed by the participant's activities to the clearing agency?
- Should the Commission consider a higher or lower threshold for net capital than the proposed $50 million amount? Please explain and describe the rationale for the desired threshold amount.
- Should the Commission consider providing for the adjustment of the $50 million net capital threshold to reflect inflation, deflation or other factors? If so, how should the Commission make such adjustment?
- Would access to clearing agencies that provide CCP services by dealers or security-based swap dealers that are not currently members of such clearing agencies be significantly improved as a result of the proposed requirement?
- Are there any difficulties that clearing agencies that provide CCP services may encounter in implementing a system that seeks to scale net capital to the risk that a participant brings to a clearing agency? Would clearing agencies be able to effectively model such risks to prevent the potential of significant losses above the amounts of margin collected? How would clearing agencies seek to limit the activities of participants to prevent the risk of significant losses above the amounts of margin collected?
- Does the proposal, to permit a clearing agency to provide for a higher net capital requirement (i.e., higher than $50 million) as a condition for membership at the

clearing agency if the clearing agency demonstrates to the Commission that such a requirement is necessary to mitigate risks that could not otherwise be effectively managed by other measures, provide sufficient flexibility to be able to address potential risk management concerns? Would the proposal lead to higher or lower levels of risk at clearing agencies? Please explain.

- Should the Commission consider requiring only security-based swap clearing agencies that provide CCP services to be subject to this requirement? Please explain why or why not. In particular, are there special considerations affecting security-based swap clearing agencies that provide CCP services, such as market concentration, that make it particularly important for a person that maintains net capital equal to or greater than $50 million to have the ability to obtain membership? If so, what are those special considerations and how would this requirement address them? If not, in what ways would this requirement impact the operations of security-based swap clearing agencies that provide CCP services and other clearing agencies? Would there be any advantages or disadvantages to maintaining one requirement for all clearing agencies that provide CCP services? Please explain.

3. Proposed Rule 17Ad-22(c)

Proposed Rule 17Ad-22(c)(1) would provide that each fiscal quarter (based on calculations made as of the last business day of the clearing agency's fiscal quarter), or at any time upon Commission request, a clearing agency that performs central counterparty services shall calculate and maintain a record[50] of the financial resources necessary to meet its

50 See Exchange Act Rule 17a-1 (17 CFR 240.17a-1). Clearing agencies may destroy or otherwise dispose of records at the end of five years consistent with Exchange Act Rule 17a-6 (17 CFR 240.17a-6).

requirement in proposed Rule 17Ad-22(b)(3) and sufficient documentation to explain the methodology it uses to compute such financial resource requirement.

The Commission preliminarily believes that it would be appropriate to require clearing agencies that provide CCP services to make these calculations quarterly or at any time based on the request of the Commission because this proposed requirement would provide a periodic update of the financial resources that are needed as market conditions change, while also providing flexibility for the Commission to request such calculations on a real-time basis, which may be useful during periods of market stress or other circumstances where more timely information is desired. These calculations and related documentation should help the Commission in its oversight of clearing agencies' compliance with proposed Rule 17Ad-22(b)(3) by providing a clear record of the method used by the clearing agency providing CCP services to maintain sufficient financial resources.

Proposed Rule 17Ad-22(c)(2) would require a clearing agency to post on its website an annual audited financial report. Each financial report would be required to (i) be a complete set of financial statements of the clearing agency for the most recent two fiscal years of the clearing agency and be prepared in accordance with U.S. generally accepted accounting principles ("U.S. GAAP"), except that for a clearing agency that is a corporation or other organization incorporated or organized under the laws of any foreign country, the financial statements may be prepared according to U.S. GAAP or International Financial Reporting Standards as issued by the International Accounting Standards Board ("IFRS"); (ii) be audited in accordance with standards of the Public Company Accounting Oversight Board by a registered public accounting firm that is qualified and independent in accordance with Rule 2-01 of Regulation S-X (17 CFR 210.2-01); and (iii) include a report of the registered public accounting firm that complies with paragraphs (a) through (d) of Rule 2-02 of Regulation S-X (17 CFR 210.2-02). The Commission preliminarily believes that requiring the posting of the clearing agency's audited annual financial report would provide an additional layer of information about the activities and financial strength of the clearing agency that market participants may find useful in assessing their use of the clearing agency's services.[51]

Request for Comment

The Commission generally requests comments on all aspects of proposed Rule 17Ad-22(c). In addition, the Commission requests comments on the following specific issues:

- Is the Commission's proposed rule regarding calculating and maintaining a record of the financial resources necessary pursuant to proposed Rule 17Ad-22(b)(3) sufficiently clear? If not, why not and what would be a better alternative?
- How do current practices by clearing agencies providing CCP services compare to the practices that the Commission proposes requiring in this rule with respect to determining needed financial resources? What are the expected incremental costs to clearing agencies that provide CCP services in connection with adding to or revising their current practices in order to implement the Commission's proposed rule?
- Should the Commission require calculation of the financial resources related information more or less frequently than quarterly? Why or why not?
- Should the Commission require any other financial statements of a clearing agency to be posted on its website, such as quarterly financial statements?
- What are the advantages and disadvantages of permitting a financial report to be in compliance with IFRS as an alternative to U.S. GAAP? If the Commission adopts the

51 The requirements of proposed Rule 17Ad-22(c)(2) concerning the audited annual financial report would apply individually to each respective clearing agency.

proposal to permit certain clearing agencies to report using IFRS as published by the IASB, should the Commission require a reconciliation to U.S. GAAP for specified accounts? If so, what accounts or items would be most useful to participants and other regulators? Would permitting only clearing agencies that are incorporated or organized under the laws of any foreign country to report under IFRS create any incentives for changing jurisdictions of incorporation or organization? If it is permitted, should we exclude certain clearing agencies, such as those who fall within one or more of the following categories: (i) those whose financial reports have not been audited by an independent public accountant inspected by the PCAOB, (ii) those who have not received a "clean" audit opinion, or (iii) those who have previously had to correct a material error in their financial statements?

4. Proposed Rule 17Ad-22(d)

Proposed Rule 17Ad-22(d) would set forth certain standards that relate to clearance and settlement processes. The areas addressed include: (1) transparent and enforceable rules and procedures; (2) participation requirements; (3) custody of assets and investment risk; (4) operational risk; (5) money settlement risk; (6) cost-effectiveness; (7) links; (8) governance; (9) information on services; (10) immobilization and dematerialization of stock certificates; (11) default procedures; (12) timing of settlement finality; (13) delivery versus payment; (14) risk controls to address participants' failures to settle; and (15) physical delivery risks. The discussion below provides greater detail regarding each respective standard covered in proposed Rule 17Ad-22(d).

Proposed Rule 17Ad-22(d)(1): Transparent and Enforceable Rules and Procedures

Proposed Rule 17Ad-22(d)(1) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide for a well founded, transparent and enforceable (legally and practically) structure for each aspect of their activities in all relevant jurisdictions.[52] The clearing agency should have written policies and procedures[53] in place that, at a minimum, address the significant aspects of a clearing agency's operations and risk management in order to provide a well founded legal framework and must be clear, internally consistent, and readily accessible by the public in order to provide a transparent legal framework. In addition, the clearing agency must be able to enforce its policies and procedures that contemplate enforcement by the clearing agency. Moreover, policies and procedures that govern or create remedial measures that a party other than the clearing agency (such as a clearing member) can undertake to seek redress or to promote compliance with applicable rules must be enforceable.[54] For the clearing agency's policies and procedures to be enforceable, a clearing agency must have appropriate means to compel parties to comply in a timely manner, including members or service providers of clearing agencies that are non-U.S. persons. The Commission preliminarily believes this proposed requirement would help to reduce the legal risks involved in the clearance and settlement process. Such legal risks include, among other things, the likelihood that the policies and procedures of a clearing agency are

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52 A relevant jurisdiction would include, among others, activities (i) in the United States, (ii) involving any means of interstate commerce, or (iii) in respect to providing clearing services to any U.S. person. For clearing agencies that operate in multiple jurisdictions, this also could include resolving possible conflicts of laws issues that the clearing agency may encounter.

53 Clearing agencies are SROs as defined in Section 3(a)(26) of the Exchange Act. A stated policy, practice, or interpretation of an SRO, such as a clearing agency's written policies and procedures, would generally be deemed to be a proposed rule change. See 17 CFR 240.19b-4.

54 The Commission preliminarily believes that proposed Rule 17Ad-22(d)(1) would augment the Exchange Act requirement that the rules of the clearing agency must provide that its participants shall be appropriately disciplined for any violation of any provision of the rules of the clearing agency. See 15 U.S.C. 78q-1(b)(3)(G).

incomplete, opaque, or not enforceable and will therefore adversely affect the functioning of the clearing agency.[55] Because they would function to reduce these legal risks, the Commission preliminarily believes that well founded, transparent and enforceable policies and procedures established by the clearing agency to underpin the clearing agency's operational and business activities are essential to a clearing agency's ability to facilitate the prompt and accurate clearance and settlement of securities transactions and safeguard securities and funds as required for the protection of investors by Section 17A of the Exchange Act.[56]

Request for Comment

The Commission generally requests comments on all aspects of proposed Rule 17Ad-22(d)(1). In addition, the Commission requests comments on the following specific issues:

- Is the Commission's proposed rule regarding policies and procedures providing for a well founded, transparent, and enforceable legal framework sufficiently clear? If not, why not? Is there a better alternative?
- How would this proposal affect the current practices of clearing agencies in formulating policies and procedures? Would the proposed rule affect the costs of providing clearing agency services? Please explain.
- What are the advantages and disadvantages of taking into account that legal risks may vary by the types of services offered by clearing agencies and whether the clearing agency operates in multiple jurisdictions? Are there any considerations, such as issues concerning compliance with regulations under various jurisdictions, that the

55 See generally, RSSS Recommendation 1, Legal Framework and RCCP Recommendation 1, Legal Risk.

56 15 U.S.C. 78q-1(a)(1)(A).

Commission should take into account for clearing agencies operating in multiple jurisdictions?

- Should the Commission consider more prescriptive rules to define how clearing agencies would provide for a well founded, transparent and enforceable legal framework? Please explain why or why not. Alternatively, should the Commission consider more prescriptive rules that would apply in the context of approval of a clearing agency's application for registration?
- Should the Commission require a clearing agency to submit legal opinions or other supporting evidence to demonstrate the legal adequacy of the mechanisms at the clearing agency that are in place to handle participant defaults?

Proposed Rule 17Ad-22(d)(2): Participation Requirements

Proposed Rule 17Ad-22(d)(2) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the clearing agency. This proposed requirement is intended to reduce the likelihood of defaults by participants, while also providing flexibility to tailor standards that are linked to the obligations of the participant. As a result, the Commission preliminarily believes this requirement would protect investors and facilitate prompt and accurate clearance and settlement by promoting membership standards at clearing agencies that are likely to limit the potential for defaults.

The proposed rule also would require clearing agencies to have procedures in place to monitor that participation requirements are met on an ongoing basis. Operational and financial stability of participants is subject to market forces and can therefore change over time. Because participants collectively contribute to the operational and financial stability of a clearing agency, the Commission preliminarily believes that the proposed requirement to continue to monitor compliance with the clearing agency's participation requirements supports the Exchange Act requirement that clearing agencies are able to facilitate prompt and accurate clearance and settlement.[57]

In addition, clearing agencies would be required to have participation requirements that are objective,[58] publicly disclosed, and facilitate fair and open access.[59] The Commission preliminarily believes this requirement would foster compliance with the requirement under Section 17A of the Exchange Act that the rules of a clearing agency must not be designed to permit unfair discrimination in the admission of participants by requiring standards that are designed to be measurable, open and fair.[60]

Request for Comment

The Commission generally requests comments on all aspects of proposed Rule 17Ad-22(d)(2). In addition, the Commission requests comments on the following specific issues:

57 15 U.S.C 78q-1(b)(3)(A).

58 Objective criteria would generally include, but not be limited to, criteria that are based on measureable facts such as capital requirements.

59 Having open access, in part, involves having a process for admission of participants that does not unfairly discriminate. See 15 U.S.C. 78q-1(b)(3)(F) ("The rules of a clearing agency... are not designed to permit unfair discrimination in the admission of participants or among participants in the use of the clearing agency"). In addition, the Dodd-Frank Act added Section 3C to the Exchange Act which provides in relevant part: "(2) OPEN ACCESS.—The rules of a clearing agency described in paragraph (1) shall— (A) prescribe that all security-based swaps submitted to the clearing agency with the same terms and conditions are economically equivalent within the clearing agency and may be offset with each other within the clearing agency; and (B) provide for non-discriminatory clearing of a security-based swap executed bilaterally or on or through the rules of an unaffiliated national securities exchange or security-based swap execution facility." Pub. L. No. 111-203 § 763(a) (adding Section 3C to the Exchange Act).

60 15 U.S.C. 78q-1(b)(3)(F).

- Is the Commission's proposed rule regarding participation requirements sufficiently clear? If not, why not and what would be a better alternative?
- How do current practices of registered clearing agencies with respect to participation standards compare to the proposed requirements in this rule? Are there any expected costs or benefits to clearing agencies in connection with adding to or revising their participation standards in order to implement this portion of the Commission's proposed rule?
- Should the Commission's proposed rule regarding participation requirements be more specific? If so, why and in what way? Should the Commission's proposed rule regarding participation requirements be less specific to allow for greater flexibility? If so, why and in what way?
- Should more specific monitoring obligations be imposed to ensure compliance with participation standards? For example, should the Commission consider mandating an independent review of the process for monitoring participants' compliance with the clearing agency's participation requirements? Why or why not?

Proposed Rule 17Ad-22(d)(3): Custody of Assets and Investment Risk

Proposed Rule 17Ad-22(d)(3) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to hold assets in a manner whereby risk of loss or of delay in access to them is minimized. Minimizing the risk of loss or delay in access is intended to refer to holding assets in ways that, to the extent reasonably practicable, would limit the potential for loss of those assets and delay in access to them. For example, the Commission is aware that clearing agencies currently seek to minimize the risk of loss or delay in access by holding assets that are highly-liquid (e.g., cash, U.S. Treasury securities or securities issued by a U.S. government agency) and engaging banks to custody the assets and facilitate settlement. Compliance with the proposed requirement is intended to improve the ability of the clearing agency to meet its settlement obligations by reducing the likelihood that assets securing participant obligations to the clearing agency would be unavailable or insufficient when the clearing agency needs to draw on them. The proposed rule would also require clearing agencies to invest assets in instruments with minimal credit, market, and liquidity risks. A requirement that a clearing agency hold assets in instruments with minimal credit, market and liquidity risk may promote the clearing agency's ability to retrieve these assets promptly. That, in turn, could help to increase the potential for a clearing agency to timely meet its settlement obligations to its participants.

The Commission preliminarily believes that proposed Rule 17Ad-22(d)(3) would strengthen the requirement in Section 17A(b)(3)(F) of the Exchange Act that the rules of a clearing agency must be designed to ensure the safeguarding of securities and funds in the custody or control of the clearing agency or for which the clearing agency is responsible.[61] In this way, the Commission preliminarily believes the proposed rule would also promote protection of the financial market served by the clearing agency.

<u>Request for Comment</u>

The Commission generally requests comments on all aspects of proposed Rule 17Ad-22(d)(3). In addition, the Commission requests comments on the following specific issues:

- Are the proposed rule's requirements regarding custody and investment of assets sufficiently clear? If not, why not and what would be a better alternative?

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61 15 U.S.C. 78q-1(b)(3)(F).

- How do current practices of clearing agencies for holding or investing in assets compare to the Commission's proposal? What are the expected incremental costs to clearing agencies in connection with adding to or revising these current practices in order to comply with the Commission's proposed rule?
- Are there any other factors not mentioned that the Commission should take into consideration with respect to minimizing custody of assets and investment risk?
- Should clearing agencies ever be permitted to hold assets in instruments that do not have minimal credit, market and liquidity risk? If so, why and under what circumstances?
- What measures should clearing agencies have in place to minimize risk of loss or delay in access to assets? Should the proposed rule specify any such measures?

Proposed Rule 17Ad-22(d)(4): Identification and Mitigation of Operational Risk

Proposed Rule 17Ad-22(d)(4) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to identify sources of operational risk and minimize these risks through the development of appropriate systems, controls, and procedures. A clearing agency that develops systems, controls and procedures which, taken as a whole, are designed to limit the identified sources of operational risk to the extent reasonably practicable would be able to satisfy this requirement. The proposed rule also would require clearing agencies to implement systems that are reliable, resilient and secure and have adequate scalable capacity. This should help to ensure that clearing agencies are able to operate with minimal disruptions, even during times of market stress when there may be greater demands on their systems due to higher volume. In addition, the proposed rule would require that clearing agencies have business continuity plans that allow for timely recovery of operations and ensure the fulfillment of a clearing agency's obligations. This requirement would be relevant in the event of, among other things, deficiencies in information systems or internal controls, human errors, management failures, unauthorized intrusions into corporate or production systems, or disruptions from external events such as natural disasters.

The Commission preliminarily believes that the requirements under proposed Rule 17Ad-22(d)(4) should collectively help to address risks posed by potential operational deficiencies to the clearing agency and its participants. Specifically, to help limit disruptions that may impede the proper functioning of a clearing agency, the Commission preliminarily believes it is imperative that clearing agencies review their operations for potential weaknesses and develop appropriate systems, controls, and procedures to address weaknesses contemplated under the proposed rule. Moreover, the Commission preliminarily believes that maintaining reliable, resilient and secure systems with adequate backup capability, as well as continuity plans providing for timely recovery of operations, are essential components of facilitating prompt and accurate clearance and settlement. The Commission intends for proposed Rule 17Ad-22(d)(4) to complement the existing guidance provided by the Commission in its Automation Review Policy statements[62] and Interagency White Paper on Sound Practices to Strengthen the Resilience of the

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62 See Exchange Act Release Nos. 27445 (November 16, 1989), 54 FR 48704 ("ARP I") and 29815 (May 9, 1991), 56 FR 22489 ("ARP II"). Generally, the guidance in ARP I and ARP II provides for the following activities by clearing agencies: (1) performing periodic risk assessments of its automated data processing ("ADP") systems and facilities; (2) providing for the selection of the clearing agency's independent auditors by non-management directors and authorizing such non-management directors to review the nature, scope, and results of all audit work performed; (3) having an adequately staffed and competent internal audit department; (4) furnishing annually to participants audited financial statements and an opinion from an independent public accountant as to the clearing agency's system of internal control –including unaudited quarterly financial statements also should be provided to participants upon request; and (5) developing and maintaining plans to assure the safeguarding of securities and funds, the integrity of the

U.S. Financial System.[63]

Request for Comment

The Commission generally requests comments on all aspects of proposed Rule 17Ad-22(d)(4). In addition, the Commission requests comments on the following specific issues:

- Is the Commission's proposed rule regarding identification and mitigation of operational risk sufficiently clear? If not, why not and what would be a better alternative?
- How do current practices of clearing agencies with respect to operational risks compare to the practices that the Commission proposes to require in this rule? What are the expected incremental costs to clearing agencies in connection with adding to or revising their current practices relating to operational risks in order to implement the Commission's proposed rule?
- Should the Commission's proposal require a specific methodology to identify and mitigate operational risk? If so, what is the methodology and why should this methodology be required?
- Should the Commission require that business continuity plans be tested with participants on an ongoing basis or with a specified frequency? Should any other more prescriptive requirements be considered by the Commission?
- Would a clearing agency's ability to comply with the proposed rule be affected if the clearing agency's operations were outsourced to another firm? If so, how should the

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ADP system, and recovery of securities, funds, or data under a variety of loss or destruction scenarios.

63 See Exchange Act Release No. 47638 (April 7, 2003), 68 FR 17809 (April 11, 2003), available at http://www.sec.gov/news/studies/34-47638.htm.

proposed rule address these differences in compliance? Would the need to minimize operational risk require limits on the types of operations that can be outsourced by clearing agencies? Would the answer depend on whether the function was outsourced to an affiliated or unaffiliated firm? Please explain.

Proposed Rule 17Ad-22(d)(5): Money Settlement Risks

Proposed Rule 17Ad-22(d)(5) would require clearing agencies establish, implement, maintain and enforce written policies and procedures reasonably designed to employ money settlement arrangements that eliminate or strictly limit the clearing agency's settlement bank risks, that is, its credit and liquidity risks from the use of banks to effect money settlements with its participants, and require funds transfers to the clearing agency to be final when effected. The Commission notes that there are a number of arrangements that clearing agencies could establish to comply with the proposed rule. For example, a clearing agency could establish criteria for use of banks to effect money settlements with its participants that address the banks' creditworthiness, access to liquidity, and operational reliability. Where practicable, a clearing agency could use multiple settlement banks and monitor the concentration of payments among its settlement banks. A clearing agency also could employ agreements with such banks to ensure that funds transfers to the clearing agency are final when effected. In addition, where available, a clearing agency could use a central bank to effect money settlements with its participants. Use of the Federal Reserve System in the United States or other central bank would eliminate the risks associated with using a settlement bank.[64]

64 The Board of Governors of the Federal Reserve System will determine whether systemically important clearing agencies may obtain account access from the Federal Reserve System.

These proposed requirements are meant to reduce the risk that financial obligations related to the activities of a clearing agency are not timely settled or discharged with finality. Failure by a bank to effectuate timely and final settlement adversely affects the clearing agency by exposing it to credit and liquidity pressures that can destabilize the clearing agency's ability to facilitate prompt and accurate clearance and settlement. Accordingly, the Commission is proposing this new rule, which is designed to limit the potential that the money settlement arrangements cause the clearing agency to face higher levels of credit and liquidity risks and to provide assurance that funds transfers are final when effected. In addition, the Commission preliminarily believes that the proposed rule would assist a clearing agency in meeting the requirement of Section 17A(b)(3)(F) of the Exchange Act, which requires the rules of a clearing agency to be designed to assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible.[65]

Request for Comment

The Commission generally requests comments on all aspects of proposed Rule 17Ad-22(d)(5). In addition, the Commission requests comments on the following specific issues:

- Is the Commission's proposed rule regarding money settlement risk sufficiently clear? If not, why not and what would be a better alternative?
- How do current practices regarding money settlement risk of clearing agencies compare to the practices that the Commission proposes to require in this rule? What are the expected incremental costs to clearing agencies in connection with adding to or revising their current practices regarding money settlement risk in order to implement the Commission's proposed rule?

65 15 U.S.C. 78q-1(b)(3)(F).

- Would it be reasonable to eliminate the clearing agency's credit and liquidity risks from the use of banks to effect money settlements with its participants? If so, how?
- Are there other rules that the Commission should establish regarding money settlement risk management, for example, by mandating the minimum number of banks that a clearing agency may use to effect money settlements with its participants in order to avoid reliance on a small number of such banks, or by specifying characteristics of financial institutions that may be used by clearing agencies for settlement purposes? If so, what would be the appropriate rules and what would be the effect of adopting them?
- Should rules for money settlement risk management established by the Commission be uniform, or are there circumstances in which it would be appropriate for clearing agencies to accept a higher level of money settlement risk, such as when transacting in certain product categories or with certain types of customers? Could the rules proposed by the Commission limit the ability of clearing agencies to compete for certain types of business either within the United States or internationally? Why or why not?
- Should the Commission adopt rules to govern the clearing agency's use of banks that are affiliated with participants in the clearing agency? Should the Commission prohibit this practice? Please explain.

Proposed Rule 17Ad-22(d)(6): Cost-Effectiveness

Proposed Rule 17Ad-22(d)(6) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide that their operations are cost-effective in meeting the requirements of participants while maintaining the safety and security of operations. To maintain safe and secure operations, a clearing agency would need to comply with the requirements under the Exchange Act and the rules thereunder. For example, a clearing agency would need to maintain the ability to comply with any recordkeeping or other regulatory requirement. Having clearing agencies be mindful of the costs that are incurred by their participants, while maintaining such compliance, should help to reduce inefficiencies in the provision of clearing agency services. This is particularly important in circumstances where clearing agencies may not be subject to strong competitive forces (such as when there is only one clearing agency for an asset class) for the provision of their services and therefore may have less of an incentive to be cost-effective in meeting the requirements of participants. Accordingly, the Commission preliminarily believes the proposed rule is appropriate in the public interest, for the protection of investors, because it would potentially help reduce the costs incurred for clearing agency services while also maintaining appropriate standards for a clearing agency's operations.

Request for Comment

The Commission generally requests comments on all aspects of proposed Rule 17Ad-22(d)(6). In addition, the Commission requests comments on the following specific issues:

- Would the proposed rule help to assure that a clearing agency's operations are cost-effective? Does the proposed rule establish a standard for maintaining cost-effectiveness that is sufficiently clear? If not, why not and how might the rule be altered?
- Are there any other requirements that the Commission should include in the rule to help ensure that clearing agencies are cost-effective in providing clearing and

settlement services while also maintaining safe and secure operations and compliance with all regulatory requirements?

- Does any specific business model for clearing agencies help to promote cost-effectiveness? Should the business model of a clearing agency affect the type of rule regarding cost-effectiveness that should apply to the clearing agency?
- Should the Commission consider issuing additional guidance on how clearing agencies could be cost-effective in meeting the requirements of participants while maintaining safe and secure operations? If so, what type of guidance would be helpful?

Proposed Rule 17Ad-22(d)(7): Links

Proposed Rule 17Ad-22(d)(7) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to evaluate the potential sources of risks that can arise when the clearing agency establishes links either cross-border or domestically to clear trades, and to ensure that these risks are managed prudently on an ongoing basis.

Section 17A(a)(1)(D) of the Exchange Act states that the linking of all clearance and settlement facilities and the development of uniform standards and procedures for clearance and settlement will reduce unnecessary costs and increase the protection of investors and persons facilitating transactions by and acting on behalf of investors.[66] Further, Section 17A(b)(3)(F) of the Exchange Act requires that the rules of a clearing agency foster cooperation and coordination with persons engaged in the clearance and settlement of securities transactions.[67] In the

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66 15 U.S.C. 78q-1(a)(1)(D).

67 15 U.S.C. 78q-1(b)(3)(F).

clearance and settlement process, links should help deepen market liquidity and enable participants to trade in other markets.[68] However, by tying the clearing operations of different clearing agencies together, link arrangements potentially expose a clearing agency and its members to the risk management profile of another clearing organization and to the risk of financial loss if that clearing organization experiences a default or is otherwise unable to meet its settlement obligations.[69]

Although the design and operation of each link will present a unique risk profile, clearing agencies potentially face legal, operational, credit and liquidity risks from link arrangements. In addition, because links can create interdependencies, clearing agencies may be affected by systemic risk if there are deficiencies in these arrangements. The Commission preliminarily believes that requiring clearing agencies to evaluate and monitor any link arrangements they maintain is essential to protect the marketplaces that clearing agencies serve because the requirement would reduce the likelihood that such arrangements perpetuate risks that could create disruptions in the operations of clearing agencies. Accordingly, the Commission is proposing this rule, which would require clearing agencies to evaluate and manage the risks associated with its links.

Request for Comment

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68 For example, The Depository Trust Company's ("DTC") Canadian Link Service allows qualifying DTC participants to clear and settle valued securities transactions with participants of a Canadian securities depository. The link is designed to facilitate cross-border transactions by allowing participants to use a single depository interface for U.S. and Canadian dollar transactions and eliminate the need for split inventories. See Exchange Act Release Nos. 52784 (November 16, 2005), 71 FR 70902 (November 23, 2005) and 55239 (February 5, 2007), 72 FR 6797 (February 13, 2007) (File No. SR-DTC 2006-15).

69 A clearing agency may be required to enter into a participant agreement with the other clearing organization as part of the link arrangement, which includes sharing in the loss allocations of that clearing organization. See RCCP 4.10.6, supra note 29.

The Commission generally requests comments on all aspects of proposed Rule 17Ad-22(d)(7). In addition, the Commission requests comments on the following specific issues:

- Is the Commission's proposed rule regarding evaluating link arrangements and prudently managing the associated risks on an ongoing basis sufficiently clear? If not, why not and how might the rule be stated more clearly?
- How do current practices of clearing agencies with respect to link arrangements meet or fail to meet the standard that the Commission proposes to require in this rule? What are the expected incremental costs to clearing agencies in connection with adding to or revising their current practices for link arrangements to comply with the Commission's proposed rule?
- Should the Commission include specific requirements regarding the clearing agency's responsibility to evaluate a link for, among other things, the other clearing organization's structure, financial strength, regulatory and disciplinary history, disaster recovery, banking relationships and lines of credit, and risk management controls?
- Should the Commission establish additional requirements for clearing agencies that create linkages with other parties, such as information reporting requirements to the Commission? Would such additional requirements reduce or increase the likelihood that linkages would be established in appropriate circumstances?
- How could clearing agencies ensure that the laws and contractual rules governing linked systems support the design of the link and provide adequate protection to both clearing agencies and their participants? Are additional rules or requirements needed when a link is established with a non-U.S. clearing organization?

- Should the Commission place any limits on or promote the use of linked arrangements in light of potential effects on systemic risk?

Proposed Rule 17Ad-22(d)(8): Governance

Proposed Rule 17Ad-22(d)(8) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to have governance arrangements that are clear and transparent to fulfill the public interest requirements in Section 17A of Exchange Act applicable to clearing agencies,[70] to support the objectives of owners and participants, and to promote the effectiveness of the clearing agency's risk management procedures.[71]

Clear and transparent governance arrangements promote accountability and reliability in the decisions, rules and procedures of the clearing agency because they provide interested parties (such as owners, participants, and general members of the public) with information about how such decisions are made and what the rules and procedures are designed to accomplish.[72] The key components of a clearing agency's governance arrangements include the clearing agency's

70 Section 17A(b)(3)(F) of the Exchange Act requires that the rules of a clearing agency be designed to protect investors and the public interest. 15 U.S.C. 78q-1(b)(3)(F).

71 Proposed Rule 17Ad-22(d)(8) would complement other applicable requirements concerning governance at clearing agencies that may also separately apply. These other requirements include the existing regulatory framework of Section 17A of the Exchange Act and the related requirements contemplated by proposed Rule 17Ad-25, as well as Section 765 of the Dodd-Frank Act with respect to security-based swap clearing agencies. See supra Section III.F. (proposing that clearing agencies be required to establish, implement, maintain and enforce written policies and procedures reasonably designed to identify and address existing or potential conflicts of interest). See also Exchange Act Release No. 63107, 75 FR 65882, supra note 45.

72 The Exchange Act currently requires that certain aspects of a clearing agency's governance arrangements be made clear and transparent. Section 19(b) of the Exchange Act requires that clearing agencies, as SROs, file with the Commission any proposed rule or any proposed change in, addition to, or deletion from the rules of the clearing agency, accompanied by a concise general statement of the basis and purpose of the proposed rule change. 15 U.S.C. 78s(b).

ownership structure, the composition and role of its board, the structure and role of board committees, reporting lines between management and the board, and the processes that ensure management is held accountable for the clearing agency's performance.

Governance arrangements have the potential to play an important role in making sure that clearing agencies fulfill the Exchange Act requirements that the rules of a clearing agency be designed to protect investors and the public interest and to support the objectives of owners and participants. Similarly, governance arrangements may promote the effectiveness of a clearing agency's risk management procedures by creating an oversight framework that fosters a focus on the critical role that risk management plays in promoting prompt and accurate clearance and settlement.[73]

The Commission preliminarily believes that the requirements regarding governance arrangements contained in proposed Rule 17Ad-22(d)(8) would be appropriate in the public interest and for the protection of investors because they would enhance the ability of a clearing agency to serve the interests of its various constituents and the interests of the general public while maintaining prudent risk management processes to promote prompt and accurate clearance and settlement.

<u>Request for Comment</u>

The Commission generally requests comments on all aspects of proposed Rule 17Ad-22(d)(8). In addition, the Commission requests comments on the following specific issues:

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[73] The role of governance arrangements in promoting effective risk management has also been a focus of rules recently proposed by the Commission to mitigate conflicts of interest at security-based swap clearing agencies. <u>See</u> Exchange Act Release No. 63107, 75 FR 65882, <u>supra</u> note 45.

- Is the Commission's proposed rule regarding clear and transparent governance arrangements sufficiently clear? If not, why not and how might the rule be stated more clearly?
- Would the proposed rule require clearing agencies to change their current practices with respect to governance arrangements? If so, how? What are the expected incremental costs to clearing agencies in connection with adding to or revising their current practices with respect to governance arrangements in order to implement the Commission's proposed rule?
- Are there any other requirements that should be included in the rule to promote clear and transparent governance arrangements, such as mandating specific board or ownership structures? If so, what should they be?
- Should the Commission propose more prescriptive requirements for the governance of all clearing agencies? If so, what should they be? For example, should the Commission specify certain reporting lines or board composition?
- How direct should the Commission's role be in the oversight and monitoring of the composition and activities of clearing agency boards and board committees? If the Commission's role should be more direct, what mechanisms or structure would facilitate the Commission taking such a role? For example, should the Commission consider any additional requirements related to fiduciary duties to either enhance mitigation of conflicts or address deficiencies?

Proposed Rule 17Ad-22(d)(9): Information on Services

Proposed Rule 17Ad-22(d)(9) would require clearing agencies establish, implement, maintain and enforce written policies and procedures reasonably designed to provide market participants with sufficient information for them to identify and evaluate the risks and costs associated with using clearing agencies' services. The types of information that a clearing agency may disclose, as appropriate, to its participants to satisfy this requirement include the clearing agency rulebook,[74] the costs of its services, a description of netting and settlement activities the clearing agency provides, procedures relating to participants' rights and obligations, information regarding the clearing agency's margin methodology, and information regarding the "extreme but plausible" scenarios that the clearing agency uses to stress test its financial resources. Requiring a clearing agency to disclose information sufficient for participants to identify risks and costs associated with using the clearing agency will allow participants to make informed decisions about the use of the clearing agency and take appropriate actions to mitigate their risks and costs associated with the use of the clearing agency. Accordingly, the Commission's proposed rule is designed to promote participants' understanding of the risks and costs associated with using a clearing agency's services, thereby facilitating prompt and accurate clearance and settlement, safeguarding securities and funds and protecting investors.[75]

<u>Request for Comment</u>

The Commission generally requests comments on all aspects of proposed Rule 17Ad-22(d)(9). In addition, the Commission requests comments on the following specific issues:

- Is the Commission's proposed rule regarding providing market participants with sufficient information to identify and evaluate the risks and costs associated with

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74 Because clearing agencies are SROs, their rules are published by the Commission and are generally available on each clearing agency's website. Nevertheless, discrete rule proposals may not necessarily provide a complete picture of a clearing agency's operations and risk mitigation procedures.

75 <u>See</u> 15 U.S.C. 78q-1(b)(3)(F).

using the clearing agency's services sufficiently clear? If not, why not and what would be a better alternative?

- How do current practices of clearing agencies with respect to providing market participants with information meet or fail to meet the requirements in the proposed rule? What are the expected incremental costs to clearing agencies in connection with adding to or revising their current practices in order to implement the proposed requirements?
- Should the Commission consider more detailed requirements concerning disclosure of certain matters such as pricing information and the cost of specific services, as well as default and risk management procedures? Why or why not?
- Should any of the examples of the types of information that a clearing agency may disclose be specifically required to be provided by clearing agencies to their participants or to the public?

Proposed Rule 17Ad-22(d)(10): Immobilization and Dematerialization of Stock Certificates

Proposed Rule 17Ad-22(d)(10) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to immobilize[76] and dematerialize[77] securities certificates and transfer them by book entry to the greatest extent possible when the clearing agency provides central securities depository services.[78] The

[76] Immobilization refers to any circumstance where an investor does not receive a physical certificate upon the purchase of shares or is required to physically deliver a certificate upon the sale of shares.

[77] Dematerialization is the process of eliminating physical certificates as a record of security ownership.

[78] See proposed Rule 17Ad-22(a)(2) for definition of "central securities depository services." In the U.S., DTC is currently the only registered clearing agency that provides central securities depository services.

Commission preliminarily believes that the immobilization and dematerialization of securities and their transfer by book entry would result in reduced costs and risks associated with securities settlements and custody by removing the need to hold and transfer many, if not most, physical certificates.[79] The Commission also preliminarily believes that the proposed rule would strengthen the requirement in Section 17A(b)(3)(F) of the Exchange Act that requires the rules of a clearing agency to assure the safeguarding of securities and funds that are in the custody or control of the clearing agency or for which it is responsible.[80]

Request for Comment

The Commission generally requests comments on all aspects of proposed Rule 17Ad-22(d)(10). In addition, the Commission requests comments on the following specific issues:

- Is the Commission's proposed rule regarding immobilization and dematerialization of securities certificates and transferring them by book entry to the greatest extent possible sufficiently clear? If not, why not and what would be a better alternative?
- How do current practices of clearing agencies regarding immobilization and dematerialization of securities certificates compare to the practices that the Commission proposes to require in this rule? What are the expected incremental

79 By concentrating the location of physical securities in a single central securities depository, clearing agencies are able to centralize the operations associated with custody and transfer and reduce costs through economies of scale. Virtually all mutual fund securities, government securities, options, and municipal bonds in the U.S. are dematerialized and most of the equity and corporate bonds in the U.S. market are either immobilized or dematerialized. While the U.S. markets have made great strides in achieving immobilization and dematerialization for institutional and broker-to-broker transactions, many industry representatives believe that the small percentage of securities held in certificated form impose unnecessary risk and expense to the industry and to investors. See Exchange Act Release No. 8398 (March 11, 2004), 69 FR 12921 (March 18, 2004).

80 15 U.S.C. 78q-1(b)(3)(F).

costs to clearing agencies in connection with adding to or revising their current practices in order to implement the Commission's proposed rule?

- What advantages or disadvantages might certificates have over securities held in book-entry-only form (e.g., proof of ownership in the event of a loss of electronic records of ownership)? Under what circumstances, if any, should the Commission encourage or discourage the use of physical certifications?

Proposed Rule 17Ad-22(d)(11): Default Procedures

Proposed Rule 17Ad-22(d)(11) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to make key aspects of their default procedures publicly available. The Commission preliminarily believes that this would provide certainty and predictability to market participants about the measures a clearing agency will take in the event of a participant default. Key aspects of a clearing agency's default procedures should generally include the following: (i) the circumstances in which action may be taken (e.g., what events trigger mutualization of losses); (ii) who may take those actions (e.g., division of responsibilities when clearing agencies operate links to other clearing agencies); (iii) the scope of the actions that may be taken (e.g., any limits on the total losses that would be mutualized); (iv) the mechanisms to address a clearing agency's obligations to non-defaulting participants (e.g., process for clearing trades guaranteed by the clearing agency to which a defaulting participant is a party); and (v) the mechanisms to address the defaulting participant's obligations to its customers (e.g., process for dealing with defaulting participants' customer accounts). The proposed rule also would require that clearing agencies establish default procedures that ensure that the clearing agency can take timely action to contain losses and liquidity pressures[81] and to continue meeting its obligations when due in the event of a participant default. Default procedures, among other things, are meant to reduce the likelihood that a default by a participant, or multiple participants, will disrupt the clearing agency's operations. By creating a framework of default procedures that are designed to permit a clearing agency to take actions to contain losses and liquidity pressures it faces while continuing to meet its obligations, the clearing agency should be in a better position to continue providing its services in a manner that promotes accurate clearance and settlement during times of market stress.

The Commission preliminarily believes that the requirements in proposed Rule 17Ad-22(d)(11) would increase the possibility that defaults by participants, should they occur, would proceed in an orderly and transparent manner. This is because the Commission preliminarily believes that the proposed rule would help to ensure that all participants are aware of the default process and are able to plan accordingly and that clearing agencies would have sufficient time to take corrective actions to mitigate potential losses.

Request for Comment

The Commission generally requests comments on all aspects of proposed Rule 17Ad-22(d)(11). In addition, the Commission requests comments on the following specific issues:

- Is the Commission's proposed rule requiring a clearing agency to establish default procedures and make key aspects of those default procedures publicly available sufficiently clear? If not, why not and what would be a better alternative?

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81 A clearing agency may be able to contain liquidity pressures it faces by taking actions to secure additional sources of liquidity or limiting transactions that potentially serve to drain liquidity resources.

- How do current practices of clearing agencies with respect to default procedures compare to the requirements of the proposed rule? What are the expected incremental costs to clearing agencies in connection with adding to or revising their current practices in order to implement the Commission's proposed rule?
- Should the Commission require specific default procedures for all clearing agencies, or should clearing agencies have discretion to create their own default procedures consistent with the proposed rule? Should the default procedures include a resolution plan if the clearing agency is unable to obtain sufficient financial resources?
- How much flexibility should a clearing agency have in the time it takes to manage a default and perform any liquidation of positions?

Proposed Rule 17Ad-22(d)(12): Timing of Settlement Finality

Proposed Rule 17Ad-22(d)(12) would require clearing agencies establish, implement, maintain and enforce written policies and procedures reasonably designed to ensure that final settlement occurs no later than the end of the settlement day and that intraday or real-time finality is provided where necessary to reduce risks. A clearing agency would be able to comply with this requirement by having a reasonable process for facilitating final settlement to occur no later than the end of the settlement day and for providing intraday or real-time finality where necessary to reduce risks. Intraday or real-time finality may be necessary to reduce risk in circumstances where the lack of intraday or real-time finality may impede the clearing agency's ability to facilitate prompt and accurate clearance and settlement, cause the clearing agency's participants to fail to meet their obligations, or cause significant disruptions in the securities markets.

The Commission preliminarily believes that requiring intraday or real-time finality for settlements, where such requirement is necessary to reduce risks, would facilitate prompt and accurate clearance and settlement by providing certainty that a settlement is final and irrevocable within a timeframe that is commensurate with the level of risk created by the lack of settlement finality. The risks associated with lack of settlement finality stem from the undermining of confidence that transaction obligations will be discharged by the clearing agency or its participants. Moreover, the Commission preliminarily believes that settlement finality should occur not later than the end of the settlement day to limit the volume of outstanding obligations that are subject to settlement at any one time and thereby reduce the settlement risk exposure of participants and the clearing agency.

Request for Comment

The Commission generally requests comments on all aspects of proposed Rule 17Ad-22(d)(12). In addition, the Commission requests comments on the following specific issues:

- Is the Commission's proposed rule regarding the timing of settlement finality sufficiently clear? If not, why not and what would be a better alternative?
- How do current practices of clearing agencies with respect to settlement finality compare to the practices that the Commission proposes to require in this rule? What are the expected incremental costs to clearing agencies in connection with adding to or revising their current practices in order to implement the Commission's proposed rule?
- What changes, if any, would be created by the requirement under the proposed rule that final settlement occur no later than the end of the settlement day? Does the proposed rule affect certain identifiable categories of market participants differently

than others, such as smaller entities or entities with limited operations in the U.S.? If so, how?

- Are there operational, legal or regulatory impediments to intraday or real-time settlement? Will the proposed standard make it harder for clearing agencies to conduct certain types of business for which intraday or real-time finality may be difficult? Are any additional rules or regulations needed to encourage intraday or real-time finality to reduce risks?
- Are there circumstances when the requirements of intraday, real-time or end of day settlement finality proposed by the rule are not feasible or are not beneficial? If so, in what circumstances?

Proposed Rule 17Ad-22(d)(13): Delivery versus payment

Proposed Rule 17Ad-22(d)(13) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to eliminate principal risk by linking securities transfers to funds transfers to achieve delivery versus payment ("DVP"). DVP is achieved in the settlement process when the mechanisms facilitating settlement ensure that delivery occurs if and only if payment occurs.[82]

Among other things, DVP eliminates the risk that a party would lose some or its entire principal because payment is made only if securities are delivered. The Commission preliminarily believes that clearing agencies should be required to use this payment method in order to reduce the potential that delivery of the security is not appropriately matched with payment for a security, thereby impeding the clearing agency's ability to facilitate prompt and

82 See Bank for International Settlements, Delivery Versus Payment in Securities Settlement Systems, (1992), available at http://www.bis.org/publ/cpss06.pdf. Three different DVP models can be differentiated according to whether the securities and/or funds transfers are settled on a gross (trade-by-trade) basis or on a net basis.

accurate clearance and settlement. Therefore, the Commission is proposing that clearing agencies be required to link securities transfers to funds transfers in a way that achieves DVP.

Request for Comment

The Commission generally requests comments on all aspects of proposed Rule 17Ad-22(d)(13). In addition, the Commission requests comments on the following specific issues:

- Is the Commission's proposed rule regarding using DVP to eliminate principal risk by linking securities transfers to funds transfers sufficiently clear? If not, why not and what would be a better alternative?
- How do current practices of clearing agencies for linking securities transfers to funds transfers compare to the practices that the Commission proposes to require in this rule? What are the expected incremental costs to clearing agencies in connection with adding to or revising their current practices in order to implement the Commission's proposed rule?
- What are the advantages and disadvantages of the proposed rule mandating a strict DVP standard? Does the proposed rule affect certain identifiable categories of clearing agencies differently than others, such as clearing agencies with more diversified post-trade services as compared to clearing agencies that specialize in fewer activities?
- Are there operational or legal impediments to implementing the proposed DVP rule? Would the proposed rule make it more difficult for clearing agencies to conduct certain types of business that may require a longer settlement cycle, for reasons outside of the clearing agency's control? Are any additional rules or regulations needed to support achievement of the proposed DVP rule?

- Are there circumstances when DVP is not feasible or practicable? If so, when?

Proposed Rule 17Ad-22(d)(14): Risk Controls to Address Participants' Failure to Settle

Proposed Rule 17Ad-22(d)(14) requires clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to institute risk controls, including collateral requirements and limits to cover the clearing agency's credit exposure to each participant exposure fully, that ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle when the clearing agency provides central securities depository services[83] and extends intraday credit to participants.

Clearing agencies that provide central securities depository services may sometimes extend intraday credit to participants to, among other things, facilitate timely settlements by providing participants with an additional tool to meet delivery obligations. If a participant fails to settle its obligations to the clearing agency, the clearing agency must cover those obligations to be able to continue to facilitate prompt and accurate clearance and settlement.

The Commission preliminarily believes it is important for clearing agencies that provide central securities depository services to institute risk controls, including collateral requirements and limits to cover the clearing agency's credit exposure to each participant exposure fully, that ensure timely settlement in these circumstances to address the risk that the participant may fail to settle after credit has been extended. The Commission also preliminarily believes that requiring the controls to be designed to withstand the inability of the participant with the largest payment obligation to settle, in such circumstances, would reduce the likelihood of disruptions at the clearing agency by having controls in place to account for the largest possible loss from any individual participant and thereby help the clearing agency to provide prompt and accurate

[83] See proposed Rule 17Ad-22(a)(2) for definition of "central securities depository services."

clearance and settlement during times of market stress.[84]

Request for Comment

The Commission generally requests comments on all aspects of proposed Rule 17Ad-22(d)(14). In addition, the Commission requests comments on the following specific issues:

- Is the Commission's proposed rule regarding risk controls to ensure timely settlement for a clearing agency providing central securities depository services sufficiently clear? If not, why not and what would be a better alternative?
- How do current practices of clearing agencies that provide central securities depository services compare to the practices that the Commission proposes to require in this rule? What are the expected incremental costs to clearing agencies in connection with adding to or revising their current practices in order to implement the Commission's proposed rule?
- In addition to collateral requirements and limits on credit exposure to participants, are there other controls on intra-day credit that could be effective in managing settlement risk? If so, should the Commission require the use of any of these other risk controls?
- What are the advantages and disadvantages of requiring that controls be designed to withstand a failure to settle by the participant with the largest payment obligation?
- Should the Commission require that the clearing agency be able to withstand a settlement failure by more than the largest participant? For example, should the Commission require the clearing agency be able to withstand a settlement failure by the participants with the two largest payment obligations? Why or why not?

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84 As previously indicated, IOSCO and the CPSS are currently in the process of revising their existing sets of international standards which include those related to a clearing agency's ability to withstand participant failures and to meet payment obligations.

Proposed Rule 17Ad-22(d)(15): Physical Delivery Risks

Proposed Rule 17Ad-22(d)(15) would require clearing agencies establish, implement, maintain and enforce written policies and procedures reasonably designed to disclose to their participants the clearing agency's obligations with respect to physical deliveries.[85] For example, if a clearing agency (as part of its operations) takes physical delivery of securities from its participants in return for payments of cash, then it must inform its participants of the extent of the clearing agency's obligations to make payment. A statement by the clearing agency to its participants about the clearing agency's obligations with respect to physical deliveries, among other things, would help to ensure that participants have information that is likely to enhance the participants' understanding of their rights and responsibilities with respect to using the clearance and settlement services of the clearing agency. The Commission preliminarily believes that providing such information to participants would promote a shared understanding regarding physical delivery practices between the clearing agency and its participants which could help reduce the potential for fails and thereby facilitate prompt and accurate clearance and settlement.

The proposed rule would also require clearing agencies to reasonably design their operations to identify and manage the risks that arise in connection with their obligations for physical deliveries. The risks associated with physical deliveries could stem from, among other factors, operational limitations with respect to assuring receipt of physical deliveries and processing of physical deliveries. The Commission preliminarily believes that requiring clearing agencies to identify and manage these risks would reduce the potential that issues will arise as a result of physical deliveries because the clearing agency will have acted preemptively to deal

85 The proposed rule would provide clearing agencies with the flexibility to determine the method by which the clearing agency will state this information to its participants. However, the clearing agencies should take care to develop an approach that provides sufficient notice to its participants regarding the clearing agency's obligations.

with potential issues that may disrupt the clearance and settlement process. Accordingly, the Commission preliminarily believes this requirement would help a clearing agency to facilitate prompt and accurate clearance and settlement consistent with Section 17A of the Exchange Act.[86]

Request for Comment

The Commission generally requests comments on all aspects of proposed Rule 17Ad-22(d)(15). In addition, the Commission requests comments on the following specific issues:

- Is the Commission's proposed rule regarding providing information regarding physical delivery and identifying and managing risks associated with physical delivery sufficiently clear? If not, why not and what would be a better alternative?
- How do current practices of clearing agencies with respect to physical delivery compare to the practices that the Commission proposes to require in this rule? What are the expected incremental costs to clearing agencies in connection with adding to or revising their current practices in order to implement the Commission's proposed rule?
- What type of information would be useful for participants to receive from a clearing agency regarding the clearing agency's obligations to participants with respect to physical deliveries? What are the advantages or disadvantages of including specific disclosure requirements with respect to any of this information?
- Are there physical delivery obligations that clearing agencies should not assume or for which the Commission should consider additional restrictions?

86 15 U.S.C. 78q-1(b)(3)(F).

B. Proposed Rule 17Aj-1 Dissemination of Pricing and Valuation Information by Security-Based Swap Clearing Agencies that Perform Central Counterparty Services

The Commission is proposing Rule 17Aj-1 to incorporate requirements regarding dissemination of pricing and valuation information in the CDS Clearing Exemption Orders into the Commission's rules for security-based swap clearing agencies.[87] Recently, the Commission voted to extend these temporary conditional exemptions from certain provisions of the federal securities laws until July 16, 2011 to continue to facilitate central clearing of certain CDS.[88] The proposed rule is designed in part to continue the existing dissemination requirements from the CDS Clearing Exemption Orders which would otherwise expire along with those exemption orders.

Proposed Rule 17Aj-1 would require dissemination of pricing and valuation information by security-based swap clearing agencies that perform CCP services.[89] In particular, proposed

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87 See, e.g., the CDS Clearing Exemption Order relating to ICE Trust. "[T]his temporary extension is conditioned on ICE Trust, directly or indirectly, making available to the public on terms that are fair and reasonable and not unreasonably discriminatory: (i) all end-of-day settlement prices and any other prices with respect to Cleared CDS that ICE Trust may establish to calculate mark-to-market margin requirements for ICE Trust clearing members; and (ii) any other pricing or valuation information with respect to Cleared CDS as is published or distributed by ICE Trust." Exchange Act Release No. 63387 (November 29, 2010) 75 FR 75502 (December 3, 2010)

88 The extensions of the temporary conditional exemptions applied to central clearing of certain CDS by ICE Trust, ICE Clear Europe, CME and Eurex. See Exchange Act Release Nos. 63389 (November 29, 2010), 75 FR 75520 (December 3, 2010); 63390 (November 29, 2010), 75 FR 75518 (December 3, 2010); 63388 (November 29, 2010), 75 FR 75522 (December 3, 2010); 63387 (November 29, 2010) 75 FR 75502 (December 3, 2010) (extending the CDS Clearing Exemption Orders for ICE Clear, Eurex, CME and ICE Trust respectively).

89 Under the proposed rule, security-based swap clearing agencies would be permitted to use different approaches to make certain pricing and valuation information available to the public. For example, some may choose to engage the services of a third-party vendor while others may make the information directly available through the clearing agency's website or some other means.

Rule 17Aj-1 would require each security-based swap clearing agency that performs CCP services to make available to the public, on terms that are fair, reasonable, and not unreasonably discriminatory,[90] all end-of-day settlement prices and any other prices for security-based swaps that the clearing agency may establish to calculate its participants' mark-to-market[91] margin requirements and any other price or valuation information with respect to security-based swaps as is published or distributed by the clearing agency to its participants.[92] The Commission preliminarily believes this requirement should apply to security-based swap clearing agencies that perform CCP services because, based on the Commission's oversight experience pursuant to the CDS Clearing Exemption Orders, price and valuation information with respect to security-based swaps may often be limited and such a requirement could help to provide information to market participants that may otherwise only be available to the participants of a particular clearing agency. Clearing agencies that clear standard securities may not face similar limitations on price and valuation information. As a result, the Commission is proposing this rule only with

90 Proposed Rule 17Aj-1 does not prohibit charges that may be assessed with respect to security-based swap clearing agencies making this information available to the public as long as such charges are fair, reasonable, and not unreasonably discriminatory. The fair, reasonable, and not unreasonably discriminatory requirements for open access to information pursuant to proposed Rule 17Aj-1 are consistent with requirements the Commission adopted pursuant to the CDS Clearing Exemption Orders as well as in Rule 603(a) of Regulation NMS which requires all exchanges, alternative trading systems, and other broker-dealers that offer individual data feeds to make the data available on terms that are fair and reasonable and not unreasonably discriminatory. See 17 CFR 242.603(a).

91 In this specific context of the margin practices of security-based swap clearing agencies, the term "mark-to-market" refers to the variation margin practices used by a clearing agency to account for ongoing fluctuations in the market value of its participants' security-based swap positions.

92 Clearing agencies may destroy or otherwise dispose of records at the end of five years consistent with Rule 17a-6 of the Exchange Act. See 17 CFR 240.17a-6.

respect to security-based swap clearing agencies that perform CCP services but is requesting comment on whether the rule should apply more broadly.

As noted above, the Commission granted the CDS Clearing Exemption Orders to promote the use of CCPs with respect to CDS.[93] Section 763(b) of the Dodd-Frank Act provides that certain security-based swap clearing agencies will be deemed registered for the purpose of clearing security-based swaps ("Deemed Registered Provision").[94] The Deemed Registered Provision becomes effective on July 16, 2011.[95] After the Deemed Registered Provision becomes effective, certain clearing agencies would no longer need an exemption from registration as a clearing agency under Section 17A of the Exchange Act in order to clear security-based swaps.[96] Proposed Rule 17Aj-1 would require securities-based swap clearing agencies that perform CCP services, once registered, to make publicly available the same pricing and valuation information required by the CDS Clearing Exemption Orders.

The clearing agencies operating pursuant to the CDS Clearing Exemption Orders have been generating model end-of-day settlement prices for CDS, which they in turn provide to clearing members and use to establish margin requirements for member positions. Pursuant to

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93 See discussion supra in Section I.

94 See Pub. L. No. 111-203 § 763(b) (adding new Section 17A(*l*) to the Exchange Act. Under this Deemed Registered Provision, eligible clearing agencies will be required to comply with all requirements of the Exchange Act, and the rules thereunder, applicable to registered clearing agencies to the extent it clears security-based swaps after the effective date of the Deemed Registered Provision, including, for example, the obligation to file proposed rule changes under Section 19(b) of the Exchange Act.

95 See Pub. L. No. 111-203 § 774.

96 ICE Trust, ICE Clear Europe and CME are each eligible for the Deemed Registered Provision based on the specified criteria in Section 763(b) of the Dodd-Frank Act. See Exchange Act Release Nos. 63389 (November 29, 2010), 75 FR 75520 (December 3, 2010); 63390 (November 29, 2010), 75 FR 75518 (December 3, 2010); 63388 (November 29, 2010), 75 FR 75522 (December 3, 2010); 63387 (November 29, 2010), 75 FR 75502 (December 3, 2010) (extending the CDS Clearing Exemption Orders for ICE Clear, Eurex, CME and ICE Trust respectively).

the terms of the CDS Clearing Exemption Orders, these clearing agencies have also made this information available to the public. The Commission preliminarily believes that public availability of this information and other related pricing data has helped to improve fairness, efficiency, and market competition by making available to all market participants data that may otherwise be available to only a limited subset of market participants. For example, end-of-day settlement prices generated by security-based swap clearing agencies represent pricing during the lifecycle of a security-based swap. As a result, this end-of-day pricing information would generally not be captured as part of any pre- or post-trade market data and may therefore provide additional information for market participants to consider in determining the value of the same or similar security-based swap positions. Accordingly, the Commission is proposing Rule 17Aj-1 to incorporate the current requirements for dissemination of price and valuation information under the CDS Clearing Exemption Orders.

Request for Comment

The Commission generally requests comments on all aspects of proposed Rule 17Aj-1. In addition, the Commission requests comments on the following specific issues:

- Is the current requirement in the CDS Clearing Exemption Orders to provide certain pricing information helpful in promoting price transparency and efficiency in the CDS market? If so, why? If not, why not? Are there ways in which the requirement could be improved, for instance to ensure better access to those who may want to access the information but find it difficult to obtain?
- Have market participants found the standard to make information available to the public on terms that fair, reasonable, and not unreasonably discriminatory sufficiently

clear? If not, what type of additional guidance would be useful? Should it be expanded to apply to all clearing agencies? Why or why not?

- Is there any other pricing information, such as with respect to valuation of security-based swaps by clearing agencies, that the Commission should consider requiring security-based swap clearing agencies to make available to the public?

C. Proposed Rule 17Ad-23 Clearing Agency Policies and Procedures to Protect the Confidentiality of Trading Information of Clearing Agency Participants

The Commission is proposing Rule 17Ad-23 to require all clearing agencies to establish, implement, maintain, and enforce written policies and procedures that are reasonably designed to protect the confidentiality of transaction information received by the clearing agency. Such transaction information may include, but is not limited to, trade data, position data, and any non-public personal information about a clearing agency participant or any of its participants' customers. The Commission preliminarily believes that such policies and procedures would help to limit the potential misuse of confidential information that could impede prompt and accurate clearance and settlement and reduce confidence in the operations of the clearing agency.

The proposed rule also provides that the required written policies and procedures shall include, but are not limited to, (a) limiting access to confidential trading information of clearing members to those employees of the clearing agency who are operating the system or responsible for its compliance with applicable laws or rules and (b) limitations on personal trading by employees and agents of the clearing agency. This proposed requirement would incorporate certain conditions under the CDS Clearing Exemption Orders previously granted to security-based swap clearing agencies related to the confidential treatment of proprietary information of participants.[97] As an intermediary in security transactions, a clearing agency receives confidential information which, if not protected, could disclose the terms of market participant's trades, trading strategies, or non-public personal information. The Commission believes that the requirement that clearing agencies operating under the CDS Clearing Exemption Orders develop policies and procedures to limit access to confidential information and develop standards restricting trading that may be based on confidential information has contributed to the formation of more robust controls limiting the potential misuse of confidential information (such as trading based on non-public information) and therefore preliminarily believes that it would be appropriate for all clearing agencies to be subject to these requirements.

Request for Comment

The Commission generally requests comments on all aspects of proposed Rule 17Ad-23. In addition, the Commission requests comments on the following specific issues:

- How do clearing agencies currently maintain confidentiality of the transaction information they receive? How do those practices compare to what the proposed rule requires? What are the expected incremental costs to clearing agencies in connection

97 See, e.g., CDS Clearing Exemption Order for ICE Trust. "ICE Trust shall establish and maintain adequate safeguards and procedures to protect clearing members' confidential trading information. Such safeguards and procedures shall include: (A) limiting access to the confidential trading information of clearing members to those employees of ICE Trust who are operating the system or responsible for its compliance with this exemption or any other applicable rules; and (B) establishing and maintaining standards controlling employees of ICE Trust trading for their own accounts. ICE Trust must establish and maintain adequate oversight procedures to ensure that the safeguards and procedures established pursuant to this condition are followed". Exchange Act Release Nos. 59527 (March 6, 2009), 74 FR 10791 (March 12, 2009), Exchange Act Release No. 61119 (December 4, 2009), 74 FR 65554 (December 10, 2009) and Exchange Act Release No. 61662 (March 5, 2010), 75 FR 11589 (March 11, 2010) and 63387 (November 29, 2010) 75 FR 75502 (December 3, 2010).

with adding to or revising their current practices to implement the Commission's proposed rule?

- Is the current requirement in the CDS Clearing Exemption Orders helpful in restricting the misuse of confidential information in the CDS market? If so, why? If not why not? Are there ways in which the requirement could be improved, for instance by permitting fewer restrictions on access to information within a clearing agency?
- In addition to the types of transaction information discussed, what other kinds of transaction information do clearing agencies receive? To what extent would this information be non-public?
- How do clearing agencies monitor or restrict their employees' and agents' trading activities? What are the advantages or disadvantages of such methods?
- Should the Commission propose any specific restrictions (such as prohibitions on trading) instead of having clearing agencies develop their own policies and procedures?
- Should the Commission require the written policies and procedures of the clearing agency to provide for a clear audit trail of transaction information that is processed by the clearing agency? Please explain.
- Instead of the applying this proposed rule to all clearing agencies, should the Commission consider requiring that only certain types of clearing agencies be subject to this requirement (e.g., security-based swap clearing agencies)? Why or why not?

D. Proposed Rule 17Ad-24: Exemption from Clearing Agency Definition for Certain Registered Securities-Based Swap Dealers and Registered Security-Based Swap Execution Facilities.

Section 3(a)(23)(B) of the Exchange Act currently excludes from the definition of clearing agency certain national securities exchanges, dealers, and certain other entities.[98] These exclusions are designed to limit the potential for overlapping or duplicative requirements that may otherwise be imposed on these regulated entities. Because the Dodd-Frank Act creates new categories of entities in the security-based swap markets that may perform functions similar to the functions performed by the excluded entities under Section 3(a)(23)(B) of the Exchange Act in the traditional securities markets, the Commission is considering whether a similar exclusion from the definition of clearing agency may be warranted.

The Commission preliminarily believes that exemptions from the clearing agency definition with respect to registered security-based swap dealers' and registered security-based swap execution facilities' activities, which are comparable to functions carved out from the definition of clearing agency for dealers and exchanges in the traditional securities markets, is

98 15 U.S.C. 78c(a)(23)(B). The term "clearing agency" does not include (i) any Federal Reserve bank, Federal home loan bank, or Federal land bank; (ii) any national securities exchange or registered securities association solely by reason of its providing facilities for comparison of data respecting the terms of settlement of securities transactions effected on such exchange or by means of any electronic system operated or controlled by such association; (iii) any bank, broker, dealer, building and loan, savings and loan, or homestead association, or cooperative bank if such bank, broker, dealer, association, or cooperative bank would be deemed to be a clearing agency solely by reason of functions performed by such institution as part of customary banking, brokerage, dealing, association, or cooperative banking activities, or solely by reason of acting on behalf of a clearing agency or a participant therein in connection with the furnishing by the clearing agency of services to its participants or the use of services of the clearing agency by its participants, unless the Commission, by rule, otherwise provides as necessary or appropriate to assure the prompt and accurate clearance and settlement of securities transactions or to prevent evasion of this title; (iv) any life insurance company, its registered separate accounts, or a subsidiary of such insurance company solely by reason of functions commonly performed by such entities in connection with variable annuity contracts or variable life policies issued by such insurance company or its separate accounts; (v) any registered open-end investment company or unit investment trust solely by reason of functions commonly performed by it in connection with shares in such registered open-end investment company or unit investment trust, or (vi) any person solely by reason of its performing functions described in 15 U.S.C. 78c(a)(25)(E).

necessary and appropriate, in the public interest, and is consistent with the protection of investors because it would mitigate the potential for overlapping or duplicative requirements consistent with prior exclusions from the definition of the term clearing agency. Accordingly, pursuant to the Commission's authority under Section 36 of the Exchange Act,[99] the Commission is proposing Rule 17Ad-24 to exempt certain registered security-based swap dealers and registered security-based swap execution facilities from the definition of clearing agency.

Specifically, proposed Rule 17Ad-24 would provide that a registered security-based swap dealer would not be considered a clearing agency solely by reason of functions it performs as part of customary dealing activities, or solely because it acts on behalf of a clearing agency or a participant in connection with services performed by the clearing agency. For example, a security-based swap dealer that acts as an intermediary in making payments or deliveries or both in connection with transactions in securities as part of its customary dealing activities would not be considered a clearing agency. The exemptions in proposed Rule 17Ad-24 for security-based swap dealers mirror exclusions already applicable to dealers under Section 3(a)(23)(B) of the Exchange Act.

In addition, proposed Rule 17Ad-24 provides that a registered security-based swap execution facility would not be considered a clearing agency solely because it provides facilities for comparison of data relating to the terms of settlement of securities transactions effected on such registered security-based swap execution facility. The exemptions in proposed Rule 17Ad-

99 15 U.S.C. 78mm. Section 36 of the Exchange Act authorizes the Commission to conditionally or unconditionally exempt any person, security, or transaction, or any class of classes of persons, securities, or transactions, from any provision or provisions of the Exchange Act or any rule or regulation thereunder, by rule, regulation, or order, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

24 for security-based swap execution facilities mirror exclusions applicable to national securities exchanges under Section 3(a)(23)(B) of the Exchange Act.

The Commission cautions, however, that security-based swap dealers and security-based swap execution facilities that engage in clearing agency activities beyond the scope of the proposed exemptions could be considered a clearing agency under the broad definition in Section 3(a)(23) of the Exchange Act. Moreover, other participants in the security-based swap market could also qualify as a clearing agency given the broad definition of clearing agency under the Exchange Act.

If a participant in the security-based swap market qualified as a clearing agency, it would be required to register with the Commission. Section 763(b) of the Dodd-Frank Act adds a new Section 17A(g) to the Exchange Act, which directs entities that use instrumentalities of interstate commerce to perform clearing agency functions for security-based swaps to register with the Commission. The Commission notes that the definition of clearing agency under Section 3(a)(23)(A) of Exchange Act is defined broadly to include any person who:

- acts as an intermediary in making payments or deliveries or both in connection with transactions in securities;
- provides facilities for the comparison of data regarding the terms of settlement of securities transactions, to reduce the number of settlements of securities transactions, or for the allocation of securities settlement responsibilities;
- acts as a custodian of securities in connection with a system for the central handling of securities whereby all securities of a particular class or series of any issuer deposited within the system are treated as fungible and may be transferred, loaned, or

pledged by bookkeeping entry, without physical delivery of securities certificates (such as a securities depository); or

- otherwise permits or facilitates the settlement of securities transactions or the hypothecation or lending of securities without physical delivery of securities certificates (such as a securities depository).[100]

Based on this broad definition, the Commission preliminarily believes that certain service providers that facilitate security-based swap contract management may meet the clearing agency definition. The Commission preliminarily believes the following activities, if engaged in by security-based swap market participants, would qualify these participants as clearing agencies and therefore trigger the statutory requirement to register as clearing agencies:[101]

- Collateral Management Activities. Collateral management involves calculating collateral requirements and facilitating the transfer of collateral between counterparties. Entities that calculate net payment obligations among counterparties for security-based swaps and provide instructions for payments, including with respect to quarterly interest, credit events, and upfront fees, are likely acting as an intermediary in making payments or deliveries or both in connection with transactions in securities. As a result of acting as such an intermediary in making payments or deliveries or both in connection with transactions in securities, the

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[100] 15 U.S.C. 78c(a)(23)(A).

[101] The Commission stresses that the functions highlighted herein are not an exhaustive list and urges each security-based swap lifecycle event service provider to consider whether its functions places it within the clearing agency definition.

Commission preliminarily believes that these entities would fall within the definition of a clearing agency[102] and would generally need to register.

- Trade Matching Services. "Matching service" is the term that is used to describe the process whereby an intermediary compares each market participant's trade data regarding the terms of settlement of securities transactions, in order to reduce the number of settlements of securities transactions, or to allocate securities settlement responsibilities. An intermediary that captures trade information regarding a securities transaction and performs an independent comparison of that information which results in the issuance of binding matched terms to the transaction is providing matching services and falls within the definition of clearing agency.[103] As a result of comparing each market participant's trade data regarding the terms of settlement of securities transactions, in order to reduce the number of settlements of securities transactions, or to allocate securities settlement responsibilities, the Commission preliminarily believes that entities providing these trade "matching services" with respect to security-based swaps would meet the statutory definition of a clearing agency[104] and would generally need to register.[105] However, the Commission also preliminarily believes that providing preliminary comparisons, such as those provided

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102 See supra note 98 and accompanying text.

103 See also Exchange Act Release No. 39829 (April 6, 1998), 63 FR 17943 (April 13, 1998) (File No. S7-10-98) ("A vendor that provides a matching service will actively compare trade and allocation information and will issue the affirmed confirmation that will be used in settling the transaction.").

104 See supra note 98 and accompanying text.

105 See Exchange Act Release No. 63727 (January 14, 2011) 76 FR 3859 (January 21, 2011) (discussing generally, at footnotes 20 through 22 and the accompanying text, the confirmation process for security-based swap transactions and the Commission's preliminary expectations about the role of matching services in that setting).

by certain affirmation and novation service providers that are followed by independent comparisons that result in the issuance of legally binding matched terms, would generally not fall within the definition of clearing agency. Similarly, the Commission preliminarily believes that reconciliation service providers that function solely to permit parties to reconcile trade information records with their counterparties would generally not fall within the definition of clearing agency.

- Tear Up/Compression Services ("Tear Up services").[106] Based on discussions between the Commission staff and market participants, the Commission understands that Tear Up service providers generally operate in the following manner:
  - Tear Up services execute an algorithm seeking to reduce the gross notional value of trades and the total number of trades but do not alter the counterparty risk or market risk associated with the trades beyond specified parameters.
  - When using a Tear Up service, the users send all transactions they are willing to terminate to the service. Each user sets tolerances for counterparty exposures it is willing to absorb and how much money it is willing to pay in trade termination costs. The submitted transactions are matched using an algorithm and tolerances specified by the user.

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106 Tear-up or multilateral portfolio trade compression services for OTC derivatives seek to eliminate unnecessary or duplicative trades from the market while maintaining a market participant's overall exposure or risk in the market. This allows dealers to reduce operational risk, freeing up liquidity and capital. By reducing the gross notional outstanding of OTC derivatives in normal times, portfolio trade compression provides effective measures to address the risk associated with uncoordinated, disorderly close-out transactions in individual dealers of the positions of a defaulting major dealer. Compression is offered by several vendors and major market participants are now engaged in regular compression exercises. See Financial Stability Board, Implementing OTC Derivatives Market Reforms, (October 25, 2010), available at http://www.Financialstabilityboard.org/publications/r_101025.pdf.

- The service then proposes terminations across all parties who participated, including, payments for termination. The users consider the proposal, check their own records, and, if they choose to accept the proposal, fax or otherwise notify their acceptance to the service. If the service receives acceptances from all users, the transaction is considered binding and the relevant transactions are considered terminated.
- The users generally exchange payments and confirmations outside the service. The Tear Up service will send the completed files to a third party service provider for matching and the "torn up" transactions are terminated in bulk at the security-based swap data repository. The security-based swap data repository maintains a record of which parties terminated the "torn up" trades.

The Commission preliminarily believes that a Tear Up service provider that performs these functions would generally fall within the definition of clearing agency and would need to register because, among other activities, it would be acting as an intermediary that provides facilities for the comparison of data regarding the terms of settlement of securities transactions, to reduce the number of settlements of securities transactions, or the allocation of securities settlement responsibilities.[107]

The Commission requests comment on all aspects of the proposed exemptions from the definition of clearing agency for registered security-based swap dealers and registered security-based swap execution facilities in proposed Rule 17Ad-24. The Commission also requests comments on which activities fall within the definition of clearing agency, particularly within the context of activities in the security-based swap market. In addition, the Commission requests

[107] See supra note 98 and accompanying text.

comments on the following specific issues:

- What are the advantages or disadvantages of the Commission granting the proposed exemptions from the definition of clearing agency? If there are disadvantages to these proposed exemptions, what are they and how do they compare to the benefits?
- Under what circumstances are market participants likely to use the proposed exemptions for registered security-based swap dealers and registered security-based swap execution facilities? Are there any additional terms or conditions that the Commission should consider imposing with respect to the proposed exemptions? Are there any advantages or disadvantages related to the proposed exemptions that the Commission should consider?
- Under Section 17A(b)(3)(I) of the Exchange Act, the rules of a clearing agency should not impose any undue burden on competition. Should the Commission augment this statutory requirement by adopting rules that prohibit clearing agencies from entering into certain types of arrangements? If so, which arrangements, and why? In particular, should the Commission promulgate rules concerning any revenue sharing arrangements used by clearing agencies? Please explain why or why not. Are revenue sharing arrangements common among clearing agencies? How are they used? Are revenue sharing arrangements a manner of directing funds to a subset of clearing members, which funds otherwise could support a general reduction of clearing costs that could be equitably distributed among members? If the Commission adopts rules regarding revenue sharing, what aspects of the revenue sharing arrangements should the rules address and how might the rules be designed to promote competition and fair access to the clearing agency? If the Commission

promulgates rules regarding certain arrangements, how should the Commission mitigate the potential risk of unduly limiting the ability of clearing agencies to develop new commercial arrangements?

- Are there any additional entities for which the Commission should consider providing exemptions with respect to the definition of clearing agency, particularly in the context of the security-based swap market? If so, why would providing such exemptions be necessary or appropriate in the public interest, and consistent with the protection of investors? Under what terms and conditions should the Commission consider providing such exemptions?
- Is there additional information about any of the security-based swap services described by the Commission that would affect the consideration of whether these activities trigger the definition of clearing agency?
- Are there any other security-based swap services that may fall within the clearing agency definition? If so, what are those services? Why would they be appropriately classified as clearing agency functions?
- If a security-based swap clearing agency that does not provide CCP services is required to register with the Commission as a clearing agency, are there certain requirements that are applicable or proposed to be applicable to other clearing agencies that should not apply to these security-based swap clearing agencies? For example:
    - Should non-CCP security-based swap clearing agencies be subject to proposed Regulation MC,[108] which the Commission proposed on October 14, 2010 to

[108] See Exchange Act Release No. 63107, 75 FR 65882, supra note 45.

mitigate the potential conflicts of interest that could exist at certain entities, including security-based swap clearing agencies, through conditions and structures relating to ownership, voting, and governance of these entities? Why or why not? Should proposed Regulation MC apply to some but not all security-based swap clearing agencies that do not provide CCP services? If so, which ones?

- o Should non-CCP security-based swap clearing agencies be subject to proposed Rule 17Ad-25, which would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to identify and address existing or potential conflicts of interest? Why or why not? Should proposed Rule 17Ad-25 apply to some but not all security-based swap clearing agencies that do not provide CCP services? If so, which ones?
- o Should non-CCP security-based swap clearing agencies be subject to proposed Rule 17Ad-26, which would require each clearing agency to establish governance standards for its board or board committee members? Why or why not? Should proposed Rule 17Ad-26 apply to some but not all security-based swap clearing agencies that do not provide CCP services? If so, which ones?

- What are the costs associated with requiring the types of entities described above that do not offer CCP services to register as a clearing agency and operate as an SRO (including compliance with ongoing SRO rule filings requirements)? Please consider both the initial and ongoing costs, and please consider the burdens that such requirements may place on the ability of these entities to operate in a commercially viable manner. Are there competitors who might offer competing services (either in the United States or abroad) without being subject to these requirements? Are these costs offset by regulatory requirements or industry commitments to use certain security-based swap service providers that fall within the definition of a clearing agency? What implications would registration of these entities have for the security-based swap markets more generally, and for the availability of their services to market participants?

E. Proposed Amendment of Rule 17Ab2-1: Registration of Clearing Agencies

The Commission is proposing to amend Rule 17Ab2-1(c) regarding the registration of clearing agencies. Rule 17Ab2-1(c) currently provides that, if requested by an applicant, the Commission may grant a temporary registration providing for exemptions from certain registration requirements in Section 17A(b)(3) of the Exchange Act. Prior to the Dodd-Frank Act's amendments to the Exchange Act, the Commission was not restricted in its ability to grant exemptions from registration requirements to any category of clearing agencies. Therefore, the exemptions discussed in Rule 17Ab2-1(c) applied with respect to all clearing agencies.

The Dodd-Frank Act amended Section 36 of the Exchange Act and altered the Commission's authority to provide exemptions from the registration requirements applicable to security-based swap clearing agencies pursuant to Section 17A(g) of the Exchange Act.[109] Accordingly, the Commission proposes to amend Rule 17Ab2-1 to reflect these changes. Specifically, the proposal would amend Rule 17Ab2-1(c) to clarify that when granting a temporary registration, the Commission may do so for "a specific period of time and may exempt, other than for purposes of section 17A(g) of the Act, the registrant from one or more of the requirements...". The Commission preliminarily believes this proposed amendment to Rule

109 See Section 772 of Pub. L. No. 111-203, 124 Stat. 1376 (2010) amending Section 36 of the Exchange Act.

17Ab2-1(c), clarifying how the rule would operate in light of changes to the Commission's exemptive authority under Section 36 of the Exchange Act with respect to Section 17A(g) of the Exchange Act, is appropriate given the change to the Commission's exemptive authority under Section 36 of the Exchange Act effected by the Dodd-Frank Act.[110]

The Commission also proposes other technical changes to Rule 17Ab2-1(c) unrelated to the Dodd-Frank Act that the Commission preliminarily believes would help in the administration of the rule pertaining to temporary registrations and would thereby be appropriate in the public interest, for the protection of investors.[111] Specifically, the Commission proposes to amend Rule 17Ab2-1(c) to clarify that the temporary registration may be issued at the discretion of the Commission. The Commission preliminarily believes that the ability to grant a temporary registration provides useful flexibility to further evaluate whether a clearing agency is meeting required standards before granting a permanent registration. Operational, resource, internal control or other issues may only become apparent after a clearing agency has commenced operations. In addition, the proposal would amend the current provision indicating that the Commission may grant the temporary registration for eighteen months or such longer period as the Commission may provide by order, to state that the Commission may grant the temporary registration for twenty-four months or such longer period as the Commission may provide by order.[112] The Commission preliminarily believes that the temporary registration process should explicitly provide greater time to allow the clearing agency to operate before registration

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110 Id.

111 See 15 U.S.C. 78q-1(d).

112 This change would also include a conforming change to the timing for granting a non-temporary registration.

becomes final because doing so would enhance the Commission's capacity to provide oversight that promotes prompt and accurate clearance and settlement.

Request for Comment

The Commission generally requests comments on all aspects of the proposed amendments to Rule 17Ab2-1. In addition, the Commission requests comments on the following specific issues:

- Are the proposed changes to Rule 17Ab2-1 setting forth the restrictions on providing exemptions with respect to security-based swap clearing agencies sufficiently clear?
- Would any additional changes to Rule 17Ab2-1 regarding how the clearing agency registration requirements apply with respect to security-based swap clearing agencies be beneficial to market participants?
- What are the advantages and disadvantages of the proposed changes to the temporary registration process, such as stating the temporary registration may be issued at the discretion of the Commission and the revisions to the timeframe for the temporary registration?

F. Proposed Rule 17Ad-25: Clearing Agency Procedures to Identify and Address Conflicts of Interest

The Commission is proposing Rule 17Ad-25 to require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to identify and reasonably existing or potential conflicts of interest.[113] For example, there may be actual or

[113] Proposed Rule 17Ad-25 would complement other applicable requirements concerning conflicts of interests at clearing agencies that may also separately apply. These other requirements include the existing regulatory framework of Section 17A of the Exchange Act and the conflicts-related requirements contemplated by proposed Rule 17Ad-22(d)(8) as well as Section 765 of the Dodd-Frank Act with respect to security-based swap clearing agencies. See supra Section III.A. (proposing that clearing agencies be required

potential conflicts of interest between the activities of a clearing agency and the interests of its participants or board members, which could affect decision making by officers or directors or actions by participants in seeking to influence its operations. The proposed rule also would require the clearing agency's policies and procedures to be reasonably designed to minimize conflicts of interest in decision making by the clearing agency.

The Commission preliminarily believes it is important for clearing agencies to evaluate their activities and determine potential sources for conflicts of interests that exist within their organization and to reasonably address such conflicts so that they do not disrupt the clearing agency's ability to facilitate prompt and accurate clearance and settlement. The Commission also preliminarily believes that requiring clearing agencies, under proposed Rule 17Ad-25, to have reasonably designed policies and procedures to minimize conflicts of interest in decision making by the clearing agency would facilitate the development of tailored policies and procedures that mitigate conflicts specific to the clearing agency's business. Moreover, the Commission preliminarily believes the proposed rule would be useful in facilitating its oversight of clearing agencies by providing a documented plan against which the Commission could evaluate a clearing agency's efforts to mitigate conflicts and potentially provide the Commission with a better understanding of the potential sources of conflicts for a specific clearing agency.

Request for Comment

The Commission generally requests comments on all aspects of proposed Rule 17Ad-25. In addition, the Commission requests comments on the following specific issues:

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to have governance arrangements that are clear and transparent to fulfill Exchange Act requirements and to support the objectives of owners and participants and promote the effectiveness of the clearing agency's risk management procedures). See also Exchange Act Release No. 63107, 75 FR 65882, supra note 45.

- Under the proposal, clearing agencies would be required to establish, implement, maintain and enforce written policies and procedures reasonably designed to identify and address existing or potential conflicts of interest. Such policies and procedures would also be required to be reasonably designed to minimize conflicts of interest in decision making by the clearing agency. Should the Commission require any specific measures to address conflicts of interests, such as mandating certain boards or board committee compositions with respect to all clearing agencies instead of using a policies and procedures approach? What are the advantages and disadvantages of a more prescriptive approach?
- What, if any, additional guidance by the Commission would be helpful regarding how clearing agencies should evaluate their own activities and determine the potential sources of conflicts?
- Should the Commission consider requiring only certain types of clearing agencies (e.g., security-based swap clearing agencies) to be subject to this requirement? Please explain why or why not. Are there special considerations, such as market concentration, affecting security-based swap clearing agencies that make it particularly important for them to establish, implement, maintain and enforce written policies and procedures to identify and address existing or potential conflicts of interest? If so, what are those special considerations and how would this requirement address them? If not, how would various types of clearing agencies be affected by this requirement? Would there be advantages to maintaining one requirement for all clearing agencies? Why or why not?

G. Proposed Rule 17Ad-26: Standards for Board or Board Committee Directors

The Commission is proposing Rule 17Ad-26 to require clearing agencies to establish governance standards for their directors serving on the board or board committees. The Commission preliminarily believes that directors serving on the board and board committees of a clearing agency play a vital role in creating a framework that supports prompt and accurate clearance and settlement because of their role in the decision-making process within a clearing agency. Accordingly, the expertise, diversity of perspectives, conduct and incentives of directors serving on the board and board committees of a clearing agency are likely to affect its effective operation. For example, a lack of expertise by board members or board committee members may deter them from challenging decisions by management and lessen the potential that management will escalate appropriate issues for the board's consideration. In addition, clearing agencies should consider the extent to which persons who have been found to have violated the securities laws, or other similar laws or statutes, may not be fit to serve on the clearing agency's board or board committees. Moreover, a lack of clear guidance as to the roles and responsibilities of directors and procedures for assessing their performance may negatively impact the efficient functioning of the clearing agency.

Therefore, the Commission is proposing Rule 17Ad-26 to require that clearing agencies establish and articulate baseline standards for appointing and retaining their directors, which may help to increase the potential that directors' actions will benefit the clearing organization. The proposed rule specifies that the clearing agency's standards must address the following areas:

- a clear articulation of the roles and responsibilities of directors serving on the clearing agency's board and any board committees;

- director qualifications providing criteria for expertise in the securities industry, clearance and settlement of securities transactions, and financial risk management;[114]
- disqualifying factors concerning serious legal misconduct, including violations of the federal securities laws; and.[115]
- policies and procedures for the periodic review by the board or board committees of the performance of individual members.

The proposed rule would require the clearing agency to clearly articulate the roles and responsibilities of directors serving on the clearing agency's board and any board committees. This would involve the clearing agency setting forth the duties of directors and the functions within the clearing agency for which they are responsible. The Commission preliminarily

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114 The Commission notes that in other contexts under the Exchange Act certain persons have been required to meet qualification standards. For example, Section 15(b)(7) requires all Commission-registered brokers and dealers to meet such standards of operational capability and all natural persons associated with registered brokers and dealers to meet such standards of training, experience, competence, and such other qualifications as the Commission finds necessary or appropriate in the public interest or for the protection of investors. See 15 U.S.C. 78o(b)(7). Section 15(b)(7) permits the Commission to rely on the rules of certain SROs in devising and administering these requirements. For example, the NASD Rule 1000 series contains registration and qualification requirements for registered representatives and principals associated with FINRA-member firms. In addition, NASD Rule 3010 requires all FINRA members to have a supervisory system that provides for, among other things, reasonable efforts to determine that all supervisory personnel are qualified by virtue of experience or training to carry out their assigned responsibilities.

115 The Exchange Act and the rules promulgated thereunder contain a number of restrictions on the ability of certain registered entities, including clearing agencies, brokers, dealers, transfer agents and other SROs, to be associated with persons subject to a "statutory disqualification," as such term is defined in Section 3(a)(39) of the Exchange Act. 15 U.S.C. 78c(a)(39). For example, Section 17A(b)(4) of the Exchange Act provides that a "registered clearing agency may, and in cases in which the Commission, by order, directs as appropriate in the public interest shall, deny participation to any person subject to a statutory disqualification." 12 U.S.C. 78q-1(b)(4).

believes that such a delineation of responsibilities will help to focus directors' efforts to areas that promote the effective operations of a clearing agency.

The proposed rule would also require that the clearing agency establish director qualifications that address the clearing agency's criteria for expertise in the securities industry, clearance and settlement of securities transactions and financial risk management because each of these would have a bearing on the director's ability to understand the operations and risks of a clearing agency. When developing these criteria, clearing agencies could consider the specialized needs of individual board committees, the overall mix of expertise within the board or on a committee, and the benefits of having members with different backgrounds (e.g., regulatory, trading, and risk management experience). The Commission preliminarily believes that this requirement would be beneficial because it could provide greater focus within a clearing agency for the selection of directors that have appropriate expertise, as determined by the clearing agency, which would facilitate the ability of the clearing agency to provide prompt and accurate clearance and settlement.

In addition, the proposed rule would require the development of disqualifying factors concerning serious legal misconduct, including violations of the federal securities laws. For example, a clearing agency might consider whether to preclude a person who has had a securities license denied, suspended, revoked or restricted by a regulatory authority from serving as a director. The Commission preliminarily believes that such qualification criteria are important with respect to identifying potential issues that would call into question the ability of the persons who are responsible for the governance of the clearing agency to ensure that it complies with applicable laws and regulations.

Finally, the proposed rule would require the clearing agency to establish policies and procedures for the periodic review by the board or a board committee of the performance of its individual members. As previously noted, the Commission preliminarily believes that directors serving on the board or board committees of a clearing agency play a vital role in creating a framework that supports prompt and accurate clearance and settlement because of their role in decision-making processes. Therefore, the Commission preliminarily believes that the board, or a board committee, should establish policies and procedures for the periodic review of the performance of the relevant directors. Such a review should consider the contributions that the directors are making to the clearing agency and to its ability to operate in an effective manner. The policies and procedures for such a review, to be developed by the clearing agency as appropriate given its particular circumstances, might include self-assessments, peer review procedures, or the use of internal or external parties or consultants to facilitate an evaluation of the performance of each relevant director.

Request for Comment

The Commission generally requests comments on all aspects of proposed Rule 17Ad-26. In addition, the Commission requests comments on the following specific issues:

- Are there any additional standards for director or board committee members that the Commission should consider requiring? Should any of the requirements in proposed Rule 17Ad-26 be modified or changed? If so, how?
- How direct should the Commission's role be in the oversight and monitoring of the composition and activities of clearing agency boards and board committees? If the Commission's role should be more direct, what mechanisms or structure would facilitate the Commission taking such a role? For example, should the Commission

consider any additional requirements related to fiduciary duties to either enhance mitigation of conflicts or address deficiencies?

- What, if any, additional guidance by the Commission would be helpful regarding standards for a clearing agency's directors?
- Should the Commission develop more or less prescriptive requirements regarding standards for directors or board committee members? What are the advantages or disadvantages of any contemplated approach?
- The Commission has previously proposed independence requirements with respect to the board and board committees of security-based swap clearing agencies. Should the boards of all clearing agencies consist of a certain proportion of independent directors? Please explain why or why not.
- Should the Commission require clearing agencies to develop any limits on the type or amount of compensation that directors may receive, such as including prohibiting compensation of independent and other non-management directors from being linked to the business performance of the clearing agency, or being subject to discretion of management? Please explain.
- Should the Commission consider requiring only certain types of clearing agencies (e.g., security-based swap clearing agencies) to be subject to this requirement? Please explain why or why not. Are there special considerations, such as market concentration, affecting security-based swap clearing agencies that make these governance requirements particularly important for them? If so, what are those special considerations and how would this requirement address them? If not, how would clearing agencies that provide different types of clearing services be affected

by the application of this requirement? Would there be advantages to maintaining one requirement for all clearing agencies? Why or why not?

H. Proposed Rule 3Cj-1 Designation of Chief Compliance Officer

The Dodd-Frank Act amended the Exchange Act to require each clearing agency to appoint a chief compliance officer ("CCO") and specifies the CCO's duties.[116] The Commission is proposing Rule 3Cj-1 to establish requirements concerning a clearing agency's CCO. In particular, proposed Rule 3Cj-1 would incorporate the duties of a clearing agency's CCO that are enumerated in Exchange Act Section 3C(j)[117] and impose additional requirements.

Consistent with the requirements under Section 3C(j) of the Exchange Act, proposed Rule 3Cj-1(a) would require each clearing agency to designate a CCO. The Commission preliminarily believes that a clearing agency would not necessarily need to hire an additional person to serve as its CCO. Instead, a clearing agency could designate an individual already employed by the clearing agency as its CCO.

Consistent with the requirements under Section 3C(j) of the Exchange Act, under proposed Rule 3Cj-1(b), each CCO shall: (1) report directly to the board or to a senior officer of the clearing agency; (2) in consultation with its board or the senior officer of the registered clearing agency, resolve any conflicts of interest that may arise; (3) be responsible for administering each policy and procedure that is required to be established pursuant to Section 3C of the Exchange Act and rules and regulations thereunder; (4) ensure compliance with the Exchange Act and the rules and regulations thereunder; (5) establish policies and procedures for the prompt remediation of any compliance issues identified by the CCO, and (6) establish and

116 Pub. L. No. 111-203, § 763(a) (adding Exchange Act Section 3C(j)).

117 Id.

follow appropriate procedures for the prompt handling of management response, remediation, retesting, and closing of non-compliance issues.

In order to clarify the requirements under Section 3C(j) of the Exchange Act, the Commission is also proposing (as part of proposed Rule 3Cj-1(e)) to define the term senior officer for purposes of proposed Rule 3Cj-1 to include the chief executive officer, or other equivalent officer. As the chief executive officer is generally the most senior officer in a clearing agency, the Commission preliminarily believes that such officer should be identified as the responsible individual for purposes of the proposed rule because it would help to promote enhanced focus on compliance issues and thereby potentially lead to more effective operations at a clearing agency.

Consistent with the requirements under Section 3C(j) of the Exchange Act, proposed Rule 3Cj-1(c) would require the CCO to prepare, sign and submit an annual compliance report that describes (i) the compliance of the clearing agency with the federal securities laws and the rules and regulations thereunder, and (ii) each policy and procedure of the clearing agency (including the code of ethics and conflict of interest policies of the registered clearing agency). Also consistent with the requirements under Section 3C(j) of the Exchange Act, proposed Rule 3Cj-1(c) would require the annual compliance report to accompany each appropriate financial report of the clearing agency that is required to be furnished to the Commission pursuant to the Exchange Act and the rules thereunder. Finally, the CCO must certify under penalty of law that the compliance report is accurate and complete.

In addition, to clarify and enhance the requirements under Section 3C(j) of the Exchange Act, the Commission is proposing to require that each annual compliance report:

- be submitted to the board of directors and audit committee (or equivalent bodies) of the clearing agency promptly after the date of execution of the required certification and prior to filing of the report with the Commission;
- be filed with the Commission in a tagged data format in accordance with the instructions contained in the EDGAR Filer Manual, as described in Rule 301 of Regulation S-T;[118] and
- be filed with the Commission within 60 days after the end of the fiscal year covered by such report.

The Commission preliminarily believes it would be appropriate to require that the annual compliance report be submitted to the board of directors and audit committee (or equivalent bodies) prior to filing of the report with the Commission because it would help to focus attention at senior levels of the clearing agency on the contents of the report that is being filed with the Commission. This in turn could help to promote a robust compliance program at the clearing agency by ensuring appropriate attention and response at the Board level.

In addition, the Commission preliminarily believes that it would be appropriate for clearing agencies to file the report with the Commission in a tagged data format in accordance with the instructions contained in the EDGAR Filer Manual in order to provide an electronic

118 The term "tag" (including the term "tagged") refers to an identifier that highlights specific information submitted to the Commission that is in the format required by the EDGAR Filer Manual, as described in Rule 301 of Regulation S-T. See 17 CFR 32.301. The term "EDGAR Filer Manual" is defined in Rule 11 of Regulation S-T as "the current version of the manual prepared by the Commission setting out the technical format requirements for an electronic submission." See 17 CFR 232.11. If the Commission adopts Rule 3Cj-1 as proposed, it is possible that clearing agencies might be required to file the annual compliance report in paper until such time as an electronic filing system is operational and capable of receiving the annual compliance report. The Commission would notify clearing agencies as soon as the electronic filing system can accept filings of annual compliance reports.

system for submitting this report that builds on an existing framework for filings to the Commission. This in turn should help to ease the potential administrative burdens on clearing agencies. As previously noted, the proposed rule would also require that the annual compliance report be filed with the Commission within 60 days after the end of the fiscal year covered by such report. The report would be subject to public availability and the Commission anticipates making such report available through its EDGAR system. The Commission preliminarily believes such time frame would be appropriate because it should give clearing agencies adequate time to review and draft a report based on actions that occurred during the prior year, while also limiting the potential that the information would be stale and thus not be as useful in the Commission's oversight of the clearing agency.

Request for Comment

The Commission generally requests comments on all aspects of proposed Rule 3Cj-1. In addition, the Commission requests comments on the following specific issues:

- Is the definition of "senior officer" appropriate? If not, is it over-inclusive or under-inclusive and how should it be defined?
- Should the Commission include in its proposed rule a requirement that a CCO's compensation must be approved by the board?
- Should the Commission include in its proposed rule a requirement that a CCO may only be removed by action of the board?
- Are there other measures that would further enhance the independence and effectiveness of a CCO and that should be prescribed in a rule, such as requiring that a CCO not perform any other functions?
- Should the Commission impose any additional duties on a CCO of a clearing agency?

- Should the Commission provide guidance in its proposed rules about the CCO's procedures for the remediation of non-compliance issues?
- What is the likely effect of the Commission's proposed rule on the development of the financial markets? Would the proposed rule impede the establishment of clearing agencies?
- Does requiring the compliance report to be filed annually with the Commission within sixty days after the end of the fiscal year covered by such report give a clearing agency enough time to prepare the report? Should the Commission consider a longer or short time frame? Please explain.
- Should the Commission require submission of the CCO compliance report to the board before or after submission to the Commission? How would submission of the compliance report to the board before or after submission to the Commission effect the board's review of the compliance report?
- Should the Commission prescribe any specific method of review by the board with respect to the CCO compliance report? For example, should the Commission require that (i) the CCO compliance report include, as appropriate, recommended actions to be taken by the clearing agency to improve compliance or correct any compliance deficiencies, (ii) the board review any such recommendations and determine whether to approve them, and (iii) the clearing agency notify the Commission if the board declines to approve such recommendations, or approves different actions than those recommended in the CCO compliance report? What are the advantages and disadvantages of such an approach? Should clearing agencies be required to have the CCO report directly to the board instead of also permitting reporting to a senior

officer of the clearing agency? What would be the advantages and disadvantages of requiring the CCO to report to the board?

IV. General Request for Comments

The Commission seeks comment on all aspects of the proposed rules with respect to clearing agencies. The Commission particularly requests comment from the point of view of investors, entities that are registered as clearing agencies, are likely to become registered clearing agencies, entities operating platforms that currently trade or clear security-based swaps, broker-dealers, and financial institutions.

Title VII requires that the SEC consult and coordinate to the extent possible with the CFTC for the purposes of assuring regulatory consistency and comparability, to the extent possible, and states that in adopting rules, the CFTC and SEC shall treat functionally or economically similar products or entities in a similar manner. In the process of developing the proposed rules the Commission staff has consulted with the CFTC staff.

The CFTC is adopting rules related to derivatives clearing organizations ("DCO") in connection with Section 725 of the Dodd-Frank Act.[119] Understanding that the Commission and the CFTC regulate different products and markets, and as such, appropriately may be proposing alternative regulatory requirements, we request comments on the effect of any differences between the Commission and CFTC approaches to the regulation of clearing agencies and DCOs respectively. Specifically, would the regulatory approaches under the Commission's proposed rulemaking pursuant to Sections 17A(d), 17A(j) and 3C(j) under the Exchange Act and the CFTC's proposed rulemaking pursuant to Section 725 of the Dodd-Frank Act result in duplicative or inconsistent requirements for market participants subject to both regulatory

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119 See 75 FR 63113 (October 14, 2010) and 75 FR 77576 (December 13, 2010).

regimes or result in gaps between those regimes? If so, in what ways do commenters believe that such duplication, inconsistencies, or gaps should be minimized? Do commenters believe the approaches proposed by the Commission and the CFTC to govern clearing agencies and DCOs are comparable? If not, why? Do commenters believe there are approaches that would result in more comparable treatment? If so, what are they and what would be the advantages and disadvantages of adopting such approaches? Do commenters believe that it would be appropriate for the Commission to adopt an approach proposed by the CFTC that differs from our proposal? If so, which one?

Commenters should, when possible, provide the Commission with empirical data to support their views. Commenters suggesting alternative approaches should provide comprehensive proposals, including any conditions or limitations that they believe should apply, the reasons for their suggested approaches, and their analysis regarding why their suggested approaches would satisfy the statutory mandates of the Exchange Act with respect to clearing agencies.

V. Paperwork Reduction Act

Certain provisions of the proposed rules would impose new "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[120] Accordingly, the Commission has submitted the information to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507 and 5 CFR 1320.11. The title of the new collection of information is Clearing Agency Standards for Operation and Governance. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

[120] 44 U.S.C. 3501 et seq.

A. Summary of Collection of Information

1. Standards for Clearing Agencies

a. Measurement and Management of Credit Exposures

Proposed Rule 17Ad-22(b)(1) contains "collection of information requirements" within the meaning of the PRA. Proposed Rule 17Ad-22(b)(1) would require a clearing agency that provides CCP services to establish, implement, maintain and enforce written policies and procedures reasonably designed to measure its credit exposures to its participants at least once each day, and limit its exposures to potential losses from defaults by its participants in normal market conditions so that the operations of the clearing agency would not be disrupted and non-defaulting participants would not be exposed to losses that they cannot anticipate or control.

b. Margin Requirements

Proposed Rule 17Ad-22(b)(2) contains "collection of information requirements" within the meaning of the PRA. Proposed Rule 17Ad-22(b)(2) would require a clearing agency that provides CCP services to establish, implement, maintain and enforce written policies and procedures reasonably designed to: (i) use margin requirements to limit its credit exposures to participants in normal market conditions; (ii) use risk-based models and parameters to set margin requirements; and (iii) review the models and parameters at least monthly.

c. Financial Resources

Proposed Rule 17Ad-22(b)(3) contains "collection of information requirements" within the meaning of the PRA. Proposed Rule 17Ad-22(b)(3) would require a clearing agency that provides CCP services to establish, implement, maintain and enforce written policies and procedures reasonably designed to maintain sufficient financial resources to withstand, at a minimum, a default by the participant to which it has the largest exposure in extreme but plausible market conditions, and if the clearing agency provides CCP services for security-based swaps then a default by the two participants to which it has the largest exposures in extreme but plausible market conditions; provided that if a participant controls another participant or is under common control with another participant, then the affiliated participants shall be collectively deemed to be a single participant.

d. Model Validation

Proposed Rule 17Ad-22(b)(4) contains "collection of information requirements" within the meaning of the PRA. Proposed Rule 17Ad-22(b)(4) would require a clearing agency that provides CCP services to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide for an annual model validation consisting of evaluating the performance of the clearing agency's margin models and the related parameters and assumptions associated with such models by a qualified person who does not perform functions associated with the clearing agency's margin models (except as part of the annual model validation) and does not report to such a person.

e. Non-Dealer Access

Proposed Rule 17Ad-22(b)(5) contains "collection of information requirements" within the meaning of the PRA. Proposed Rule 17Ad-22(b)(5) would require a clearing agency that provides CCP services to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide the opportunity for a person that does not perform any dealer or security-based swap dealer services to obtain membership at the clearing agency to clear securities for itself or on behalf of other persons.

f. Portfolio Size and Transaction Volume Thresholds Restrictions

Proposed Rule 17Ad-22(b)(6) contains "collection of information requirements" within the meaning of the PRA. Proposed Rule 17Ad-22(b)(6) would require a clearing agency that provides CCP services to establish, implement, maintain and enforce written policies and procedures reasonably designed to have membership standards that do not require that participants maintain a portfolio of any minimum size or that participants maintain a minimum transaction volume.

g. Net Capital Restrictions

Proposed Rule 17Ad-22(b)(7) contains "collection of information requirements" within the meaning of the PRA. Proposed Rule 17Ad-22(b)(7) would require a clearing agency that provides CCP services to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide a person that maintains net capital equal to or greater than $50 million with the ability to obtain membership at the clearing agency, with any net capital requirements being scalable so that they are proportional to the risks posed by the participant's activities to the clearing agency. The proposed rule also permits a clearing agency to provide for a higher net capital requirement (i.e., higher than $50 million) as a condition for membership at the clearing agency if the clearing agency demonstrates to the Commission that such a requirement is necessary to mitigate risks that could not otherwise be effectively managed by other measures, such as scalable limitations on the transactions that the participants may clear through the clearing agency, and the Commission approves the higher net capital requirement as part of a rule filing or clearing agency registration application.

h. Record of Financial Resources

Proposed Rule 17Ad-22(c)(1) contains "collection of information requirements" within the meaning of the PRA. Proposed Rule 17Ad-22(c)(1) would require that each fiscal quarter (based on calculations made as of the last business day of the clearing agency's fiscal quarter), or at any time upon Commission request, a clearing agency that performs CCP services shall calculate and maintain a record of the financial resources necessary to meet the requirement in proposed Rule 17Ad-22Ad-22(b)(3) and sufficient documentation to explain the methodology it uses to compute such financial resource requirement.

i. Annual Audited Financial Report

Proposed Rule 17Ad-22(c)(2) contains "collection of information requirements" within the meaning of the PRA. Proposed rule 17Ad-22(c)(2) would require a clearing agency to post on its website an annual financial report which must (i) be a complete set of financial statements of the clearing agency for the most recent two fiscal years and be prepared in accordance with U.S. GAAP, except that for a clearing agency that is a corporation or other organization incorporated or organized under the laws of any foreign country the financial statements may be prepared according to U.S. GAAP or IFRS, (ii) be audited in accordance with standards of the Public Company Accounting Oversight Board by a registered public accounting firm that is qualified and independent in accordance with rule 2-01 of Regulation S-X (17 CFR 210.2-01), (iii) include a report of the registered public accounting firm that complies with paragraphs (a) through (d) of Rule 2-02 of Regulation S-X (17 CFR 210.2-02).

j. Transparent and Enforceable Rules and Procedures

Proposed Rule 17Ad-22(d)(1) contains "collection of information requirements" within the meaning of the PRA. Proposed Rule 17Ad-22(d)(1) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide for a well founded, transparent, and enforceable legal framework for each aspect of its activities in all relevant jurisdictions.

k. Participation Requirements

Proposed Rule 17Ad-22(d)(2) contains "collection of information requirements" within the meaning of the PRA. Proposed Rule 17Ad-22(d)(2) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the clearing agency. Clearing agencies would also be required to have procedures in place to monitor that participation requirements are met on an ongoing basis, and to have participation requirements that are objective, publicly disclosed, and permit fair and open access.

l. Custody of Assets and Investment Risk

Proposed Rule 17Ad-22(d)(3) contains "collection of information requirements" within the meaning of the PRA. Proposed Rule 17Ad-22(d)(3) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to hold assets in a manner that minimizes risk of loss or delay in access to them and to invest assets in instruments with minimal credit, market, and liquidity risks.

m. Identification and Mitigation of Operational Risk

Proposed Rule 17Ad-22(d)(4) contains "collection of information requirements" within the meaning of the PRA. Proposed Rule 17Ad-22(d)(4) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to: (i) identify sources of operational risk and minimize them through the development of appropriate systems, controls, and procedures; (ii) implement systems that are reliable, resilient and secure, and have adequate, scalable capacity; and (iii) have business continuity plans that allow for timely recovery of operations and fulfillment of a clearing agency's obligations.

n. Money Settlement Risks

Proposed Rule 17Ad-22(d)(5) would contain "collection of information requirements" within the meaning of the PRA. Proposed Rule 17Ad-22(d)(5) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to employ money settlement arrangements that eliminate or strictly limit the clearing agency's settlement bank risks, that is, its credit and liquidity risks from the use of banks to effect money settlements with its participants, and require funds transfers to the clearing agency to be final when effected.

o. Cost-Effectiveness

Proposed Rule 17Ad-22(d)(6) would contain "collection of information requirements" within the meaning of the PRA. Proposed Rule 17Ad-22(d)(6) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to be cost-effective in meeting the requirements of participants while maintaining safe and secure operations.

p. Links

Proposed Rule 17Ad-22(d)(7) would contain "collection of information requirements" within the meaning of the PRA. Proposed Rule 17Ad-22(d)(7) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to evaluate the potential sources of risks that can arise when the clearing agency establishes links either cross-border or domestically to clear trades and ensure that the risks are managed prudently on an ongoing basis.

q. Governance

Proposed Rule 17Ad-22(d)(8) would contain "collection of information requirements" within the meaning of the PRA. Proposed Rule 17Ad-22(d)(8) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to have governance arrangements that are clear and transparent to fulfill the public interest requirements in Section 17A of the Exchange Act applicable to clearing agencies, to support the objectives of owners and participants, and to promote the effectiveness of the clearing agency's risk management procedures.

r. Information on Services

Proposed Rule 17Ad-22(d)(9) would contain "collection of information requirements" within the meaning of the PRA. Proposed Rule 17Ad-22(d)(9) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide market participants with sufficient information for them to identify and evaluate the risks and costs associated with using their services.

s. Immobilization and Dematerialization of Stock Certificates

Proposed Rule 17Ad-22(d)(10) would contain "collection of information requirements" within the meaning of the PRA. Proposed Rule 17Ad-22(d)(10) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to immobilize or dematerialize securities certificates and transfer them by book entry to the greatest extent possible if the clearing agency performs central securities depository services.

t. Default Procedures

Proposed Rule 17Ad-22(d)(11) would contain "collection of information requirements" within the meaning of the PRA. Proposed Rule 17Ad-22(d)(11) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to make key aspects of the clearing agency's default procedures publicly available and to establish default procedures that ensure that the clearing agency can take timely action to contain losses and liquidity pressures and to continue meeting its obligations in the event of a participant default.

u. Timing of Settlement Finality

Proposed Rule 17Ad-22(d)(12) would contain "collection of information requirements" within the meaning of the PRA. Proposed Rule 17Ad-22(d)(12) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to ensure that final settlement occurs no later than the end of the settlement day and that intraday or real-time finality is provided where necessary to reduce risks.

v. Delivery versus payment

Proposed Rule 17Ad-22(d)(13) would contain "collection of information requirements" within the meaning of the PRA. Proposed Rule 17Ad-22(d)(13) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to eliminate principal risk linking securities transfers to funds transfers in a way that achieves DVP.

w. Risk Controls to Address Participants' Failure to Settle

Proposed Rule 17Ad-22(d)(14) would contain "collection of information requirements" within the meaning of the PRA. Proposed Rule 17Ad-22(d)(14) would require clearing agencies that perform central securities depository services to establish, implement, maintain and enforce written policies and procedures reasonably designed to institute risk controls when the clearing agency extends intraday credit to participants, including collateral requirements and limits to cover the clearing agency's credit exposure to each participant fully, and that ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle.

If a participant controls another participant or is under common control with another participant, then the affiliated participants shall be collectively deemed to be a single participant.

x. Physical Delivery Risks

Proposed Rule 17Ad-22(d)(15) would contain "collection of information requirements" within the meaning of the PRA. Proposed Rule 17Ad-22(d)(15) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to state to its participants the clearing agency's obligations with respect to physical deliveries. Clearing agencies would also be required to identify and manage the risks that arise in connection with these obligations.

2. Dissemination of Pricing and Valuation Information by Security-Based Swap Clearing Agencies that Perform Central Counterparty Services

Proposed Rule 17Aj-1 contains "collection of information requirements" within the meaning of the PRA. Proposed Rule 17Aj-1 is designed to preserve the information dissemination requirement from the CDS Clearing Exemption Orders.[121] The proposed rule would require every security-based swap clearing agency that performs CCP services to make available to the public all end-of-day settlement prices and any other prices with respect to security-based swaps that it may use to calculate mark-to-market[122] margin requirements for its participants. Proposed Rule 17Aj-1 also would require every security-based swap clearing agency that performs CCP services to make available to the public any other pricing or valuation information with respect to security-based swaps that it otherwise publishes or makes available

121 See generally note 6 (providing citations to the CDS Clearing Exemption Orders).

122 See supra note 91 (explaining that in the specific context of the margin practices of security-based swap clearing agencies, the term "mark-to-market" implies the variation margin practices used by the clearing agency to account for ongoing fluctuations in the market value of its participants' security-based swap positions).

to its participants. Proposed Rule 17Aj-1 would not require that this information be made available to the public free of charge. Instead, it would require that the information be provided to the public on terms that are fair, reasonable and not unreasonably discriminatory.

3. Clearing Agency Policies and Procedures to Protect the Confidentiality of Trading Information of Clearing Agency Participants

Proposed Rule 17Ad-23 contains "collection of information requirements" within the meaning of the PRA. Proposed Rule 17Ad-23 would require each registered clearing agency to establish, implement, maintain and enforce written policies and procedures designed to protect the confidentiality of any and all transaction information that the clearing agency receives. Such transaction information may include, but is not limited to, trade data, position data, and any non-public personal information about a clearing agency member or participant or any of its members' or participants' customers. The proposed rule also provides that the required policies and procedures shall include, but are not limited to, (a) limiting access to confidential trading information of clearing members to those employees of the clearing agency who are operating the system or responsible for its compliance with any other applicable laws or rules and (b) standards controlling employees and agents of the clearing agency trading for their personal benefit or the benefit of others.

4. Exemption from Clearing Agency Definition for Certain Registered Securities-Based Swap Dealers and Registered Security-Based Swap Execution Facilities

Proposed Rule 17Ad-24 provides that a registered security-based swap dealer would not be considered a clearing agency solely by reason of functions performed by such institution as part of customary dealing activities, or solely because it acts on behalf of a clearing agency or a participant in connection with services performed by the clearing agency. In addition, proposed Rule 17Ad-24 provides that a registered security-based swap execution facility would not be considered a clearing agency solely because it provides facilities for comparison of data relating to the terms of settlement of securities transactions. Accordingly, the rule does not impose recordkeeping or information collection requirements, or other collections of information that require approval of the OMB under 44 U.S.C 3501, et seq. Thus, it would not be a "collection of information" within the meaning of the PRA.

5. Registration of Clearing Agencies

The proposed amendment to Rule 17Ab2-1 would mainly clarify that when granting a temporary registration the Commission may do so for "a specific period of time and may exempt, other than for purposes of Section 17A(g) of the Act, the registrant from one or more of the requirements . . .". Accordingly, the proposed rule does not impose recordkeeping or information collection requirements, or other collections of information that require approval of the OMB under 44 U.S.C 3501, et seq. Thus, it would not be a "collection of information" within the meaning of the PRA.

6. Clearing Agency Procedures to Identify and Address Conflicts of Interest

Proposed Rule 17Ad-25 contains "collection of information requirements" within the meaning of the PRA. Proposed Rule 17Ad-25 would require each clearing agency to establish, implement, maintain and enforce written policies and procedures reasonably designed to identify and address existing or potential conflicts of interest, as well as that address methods of minimizing conflicts of interest in decision-making at the clearing agency.

7. Standards for Board or Board Committee Directors

Proposed Rule 17Ad-26 contains "collection of information requirements" within the meaning of the PRA. Proposed Rule 17Ad-26 outlines the proposed standards that would a registered clearing agency would be required to establish for its board members and board committee members. These standards include at least the following areas: (i) a clear articulation of the roles and responsibilities of directors serving on the clearing agency's board and any board committees; (ii) director qualifications providing criteria for expertise in the securities industry, clearance and settlement of securities transactions, and financial risk management; (iii) disqualifying factors concerning serious legal misconduct, including violations of the federal securities laws; and (iv) policies and procedures for the periodic review by the board or a board committee of the performance of its individual members.

8. Designation of Chief Compliance Officer

Proposed Rule 3Cj-1 contains "collection of information requirements" within the meaning of the PRA. Proposed Rule 3Cj-1 would require each registered clearing agency to designate a CCO. Under proposed Rule 3Cj-1(b), the CCO would be responsible for, among other matters, establishing policies and procedures for the remediation of non-compliance issues identified by the CCO and establishing and following appropriate procedures for the prompt handling of management response, remediation, retesting, and closing of compliance issues.

Under Proposed Rule 3Cj-1(c), the CCO would also be responsible for preparing and signing an annual compliance report that contains a description of (i) the compliance of the clearing agency with respect to the federal securities laws and the rules and regulations thereunder, and (ii) each policy and procedure of the clearing agency of the compliance officer (including the code of ethics and conflict of interest policies of the registered clearing agency). This compliance report must accompany each appropriate financial report of the clearing agency that is required to be furnished to the Commission pursuant to the Exchange Act and the rules thereunder and include a certification that, under penalty of law, the compliance report is accurate and complete.

Additionally, the compliance report would be required to: (i) be submitted to the board of directors and audit committee (or equivalent bodies) of the clearing agency promptly after the date of execution of the required certification and prior to filing of the report with the Commission, (ii) be filed with the Commission in a tagged data format in accordance with the instructions contained in the EDGAR Filer Manual as described in Rule 301 of Regulation S-T, and (iii) be filed with the Commission within 60 days after the end of the fiscal year covered by such report.

B. Proposed Use of Information

1. Standards for Clearing Agencies

a. Measurement and Management of Credit Exposures

As discussed above, proposed Rule 17Ad-22(b)(1) would require a clearing agency that provides CCP services to establish, implement, maintain and enforce written policies and procedures reasonably designed to measure its credit exposures to its participants at least once each day, and limit its exposures to potential losses from defaults by its participants in normal market conditions so that the operations of the clearing agency would not be disrupted and non-defaulting participants would not be exposed to losses that they cannot anticipate or control. The purpose of the collection of information is to enable the clearing agency to monitor and limit its exposures to its participants.

b. Margin Requirements

As discussed above, proposed Rule 17Ad-22(b)(2) would require a clearing agency that provides CCP services to establish, implement, maintain and enforce written policies and procedures reasonably designed to: (i) use margin requirements to limit its credit exposures to participants in normal market conditions; (ii) use risk-based models and parameters to set margin requirements; and (iii) review the models and parameters at least monthly. The purpose of the collection of information is to enable the clearing agency to maintain sufficient collateral or margin.

c. Financial Resources

As discussed above, proposed Rule 17Ad-22(b)(3) would require a clearing agency that provides CCP services to establish, implement, maintain and enforce written policies and procedures reasonably designed to maintain sufficient financial resources to withstand, at a minimum, a default by the participant to which it has the largest exposure in extreme but plausible market conditions, and if the clearing agency provides CCP services for security-based swaps then a default by the two participants to which it has the largest exposures in extreme but plausible market conditions; provided that if a participant controls another participant or is under common control with another participant, the affiliated participant and the participant shall be deemed to be a single participant. The purpose of the collection of information is to enable the clearing agency to satisfy all of its settlement obligations in the event of a participant default.

d. Model Validation

As discussed above, proposed Rule 17Ad-22(b)(4) would require a clearing agency that provides CCP services to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide for an annual model validation. The purpose of the collection of information is to enable the clearing agency to obtain an assessment of its margin model by a qualified, independent person.

e. Non-Dealer Access

As discussed above, proposed Rule 17Ad-22(b)(5) would require a clearing agency that provides CCP services to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide the opportunity for a person that does not perform any dealer or security-based swap dealer services to obtain membership at the clearing agency to clear securities for itself or on behalf of other persons. The purpose of the collection of information is to enable more market participants to obtain indirect access to clearing agencies.

f. Portfolio Size and Transaction Volume Restrictions

As discussed above, proposed Rule 17Ad-22(b)(6) would require a clearing agency that provides CCP services to establish, implement, maintain and enforce written policies and procedures reasonably designed to have membership standards that do not require that participants maintain a portfolio of any minimum size or that participants maintain a minimum transaction volume. The purpose of the collection of information is to remove unnecessary barriers to participation in clearing agencies that provide CCP services.

g. Net Capital Restrictions

As discussed above, proposed Rule 17Ad-22(b)(7) would require a clearing agency that provides CCP services to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide a person that maintains net capital equal to or greater than $50 million with the ability to obtain membership at the clearing agency, with any net capital requirements being scalable so that they are proportional to the risks posed by the participant's activities to the clearing agency. The rule also permits a clearing agency to provide for a higher net capital requirement (i.e., higher than $50 million) as a condition for membership at the clearing agency if the clearing agency demonstrates to the Commission that such a requirement is necessary to mitigate risks that could not otherwise be effectively managed by other measures, such as scalable limitations on the transactions that the participants may clear through the clearing agency, and the Commission approves the higher net capital requirement as part of a rule filing or clearing agency registration application. The purpose of the collection of information is to remove unnecessary barriers to clearing access by market participants with a net capital level above $50 million, while at the same time facilitating sound risk management practices by clearing agencies by encouraging them to examine and articulate the benefits that higher net capital requirements would create through having clearing agencies develop scalable membership standards that links the activities any participants could potentially engage in with the potential risks posed by the participant.

h. Record of Financial Resources

As discussed above, proposed Rule 17Ad-22(c)(1) would require that each fiscal quarter (based on calculations made as of the last business day of the clearing agency's fiscal quarter), or at any time upon Commission request, a clearing agency that performs CCP services shall calculate and maintain a record of the financial resources necessary to meet the requirement in proposed Rule 17Ad-22c)(3) and sufficient documentation to explain the methodology it uses to compute such financial resource requirement. The purpose of the collection of information is to enable the Commission to monitor the financial resources of clearing agencies that provide CCP services.

i. Annual Audited Financial Report

As discussed above, proposed Rule 17Ad-22(c)(2) would require a clearing agency that provides CCP services to post on its website an annual audited financial report that must (i) be a complete set of financial statements of the clearing agency for the most recent two fiscal years and be prepared in accordance with U.S. GAAP, except that for a clearing agency that is a corporation or other organization incorporated or organized under the laws of any foreign country the financial statements may be prepared according to U.S. GAAP or IFRS; (ii) be audited in accordance with standards of the Public Company Accounting Oversight Board by a registered public accounting firm that is qualified and independent in accordance with rule 2-01 of Regulation S-X (17 CFR 210.2-01); and (iii) include a report of the registered public accounting firm that complies with paragraphs (a) through (d) of Rule 2-02 of Regulation S-X (17 CFR 210.2-02). The purpose of the collection of information is to enable the Commission to monitor the financial resources of clearing agencies that provide CCP services.

j. Transparent and Enforceable Rules and Procedures

As discussed above, proposed Rule 17Ad-22(d)(1) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide for a well founded, transparent, and enforceable legal framework for each aspect of their activities in all relevant jurisdictions. The purpose of the collection of information is to help ensure that clearing agencies' policies and procedures do not cause confusion or legal uncertainty among their participants because they are unclear, incomplete or conflict with other applicable laws or judicial precedent.

k. Participation Requirements

As discussed above, proposed Rule 17Ad-22(d)(2) has three principle requirements related to establishing, implementing, maintaining and enforcing written policies and procedures for participation requirements. First, it would require clearing agencies to require participants to have sufficient financial resources and robust operational capacity to meet their obligations. The purpose of the collection of information is to enable clearing agencies to ensure that only persons with sufficient financial and operational capacity are direct participants. Second, clearing agencies would be required to have procedures in place to monitor that participation requirements are met on an ongoing basis. The purpose of the collection of information is to help clearing agencies identify a participant experiencing financial difficulties before the participant fails to meet its settlement obligations. Third, a clearing agency's participation requirements would have to be objective, publicly disclosed, and permit fair and open access. The purpose of the collection of information is to ensure that all qualified persons can access a clearing agency's services on an equivalent basis.

l. Custody of Assets and Investment Risk

As discussed above, proposed Rule 17Ad-22(d)(3) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to hold assets in a manner that minimizes risk of loss or delay in access to them, and to invest assets in instruments with minimal credit, market, and liquidity risks. The purpose of the collection of information is to enable clearing agencies to access their financial resources quickly so that they settle securities transactions on time and at the agreed upon terms.

m. Identification and Mitigation of Operational Risk

As discussed above, proposed Rule 17Ad-22(d)(4): would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to: (i) identify sources of operational risk and minimize them through the development of appropriate systems, controls, and procedures; (ii) implement systems that are reliable, resilient and secure, and have adequate, scalable capacity; and (iii) have business continuity plans that allow for timely recovery of operations and fulfillment of a clearing agency's obligations. The purpose of the collection of information is to ensure that clearing agencies can maintain operations in the event of an operational problem, natural disaster or other similar event.

n. Money Settlement Risks

As discussed above, proposed Rule 17Ad-22(d)(5) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to employ money settlement arrangements that eliminate or strictly limit the clearing agency's settlement bank risks, that is, its credit and liquidity risks from the use of banks to effect money settlements with its participants, and require funds transfers to the clearing agency to be final when effected. The purpose of the collection of information is to promote reliability in a clearing agency's settlement operations.

o. Cost-Effectiveness

As discussed above, proposed Rule 17Ad-22(d)(6) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to be cost-effective in meeting the requirements of participants while maintaining safe and secure operations. The purpose of the collection of information is to help ensure that the services of clearing agencies do not become too expensive.

p. Links

As discussed above, proposed Rule 17Ad-22(d)(7) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to evaluate the potential sources of risks that can arise when the clearing agency establishes links either cross-border or domestically to clear trades, and ensure that the risks are managed prudently on an ongoing basis. The purpose of the collection of information is to help ensure that clearing agencies adequately assess the risks associated with establishing a link with another clearing organization.

q. Governance

As discussed above, proposed Rule 17Ad-22(d)(8) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to have governance arrangements that are clear and transparent to fulfill the public interest requirements in Section 17A of the Exchange Act applicable to clearing agencies; to support the objectives of owners and participants; and to promote the effectiveness of the clearing agency's risk management procedures. The purpose of the collection of information is to promote boards of directors that exercise sufficient oversight of the clearing agency's management and appropriately represent the interests of relevant stakeholders.

r. Information on Services

As discussed above, proposed Rule 17Ad-22(d)(9) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide market participants with sufficient information for them to identify and evaluate the risks and costs associated with using their services. The purpose of the collection of information is to help market participants identify the risks and costs associated with using the clearing agency and would allow market participants to make informed decisions about the use of the clearing agency and take appropriate actions to mitigate their risks and costs associated with the use of the clearing agency.

s. Immobilization and Dematerialization of Stock Certificates

As discussed above, proposed Rule 17Ad-22(d)(10) would require clearing agencies that perform central securities depository services to establish, implement, maintain and enforce written policies and procedures reasonably designed to immobilize or dematerialize securities certificates and transfer them by book entry to the greatest extent possible. The purpose of the collection of information is to enable clearing agencies to promote greater efficiency in the settlement of securities transactions and reduce risk by transferring securities by book entry movements.

t. Default Procedures

As discussed above, proposed Rule 17Ad-22(d)(11) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to make key aspects of their default procedures publicly available and to establish default procedures that ensure that the clearing agency can take timely action to contain losses and liquidity pressures and to continue meeting its obligations in the event of a participant default. The purpose of the collection of information is to foster a greater understanding by market participants of possible steps a clearing agency may take when a participant defaults and possibly reduce the likelihood of market participants taking actions based on incorrect information.

u. Timing of Settlement Finality

As discussed above, proposed Rule 17Ad-22(d)(12) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to ensure that final settlement occurs no later than the end of the settlement day and require that intraday or real-time finality be provided where necessary to reduce risks. The purpose of the proposed rule is to promote consistent standards of timing and reliability in the settlement process.

v. Delivery Versus Payment

As discussed above, proposed Rule 17Ad-22(d)(13) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to eliminate principal risk by linking securities transfers to funds transfers in a way that achieves delivery versus payment. The purpose of the proposed rule is to eliminate principal risk in the transfer of securities and funds.

w. Risk Controls to Address Participant's Failure to Settle

As discussed above, proposed Rule 17Ad-22(d)(14) would require clearing agencies that perform central securities depository services and extend intraday credit to participants to establish, implement, maintain and enforce written policies and procedures reasonably designed to institute risk controls, including collateral requirements and limits to cover the clearing agency's credit exposure to each participant fully, and ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle. The purpose of the collection of information is to enable clearing agencies to satisfy their settlement obligations on time and for the agreed upon terms.

x. Identification and Management of Physical Delivery Risks

As discussed above, proposed Rule 17Ad-22(d)(15) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to state to their participants the clearing agency's obligations with respect to physical deliveries and to identify and manage the risks that arise in connection with these obligations. The purpose of the collection of information is to provide the clearing agency's participants with sufficient information to evaluate the risks and costs associated with participation in the clearing agency.

2. Dissemination of Pricing and Valuation Information by Security-Based Swap Clearing Agencies that Perform Central Counterparty Services

As discussed above, proposed Rule 17Aj-1 would require security-based swap clearing agencies that perform CCP services to make available to the public all end-of-day settlement prices and any other prices with respect to security-based swaps that it may use to calculate mark-to-market margin requirements for its participants and any other pricing or valuation information with respect to security-based swaps that it otherwise publishes or makes available to its participants. The purpose of the collection of information is to help improve fairness, efficiency and market competition by providing market participants and, more generally, the public with a source of pricing data on security-based swaps that may otherwise be difficult to obtain.

3. Clearing Agency Policies and Procedures to Protect the Confidentiality of Trading Information of Clearing Agency Participants

As discussed above, proposed Rule 17Ad-23 would require each registered clearing agency to establish, implement, maintain and enforce written policies and procedures designed to protect the confidentiality of any and all transaction information that the clearing agency receives. Such transaction information may include, but is not limited to, trade data, position data, and any non-public personal information about a clearing agency member or participant or any of its members or participant's customers. The proposed rule also provides that the required policies and procedures shall include, but are not limited to: (a) limiting access to confidential trading information of clearing members to those employees of the clearing agency who are operating the system or responsible for its compliance with any other applicable laws or rules and (b) standards controlling employees and agents of the clearing agency trading for their personal benefit or the benefit of others. The purpose of the collection of information is to foster confidence in clearing agencies by market participants.

4. Clearing Agency Procedures to Identify and Address Conflicts of Interest

As discussed above, proposed Rule 17Ad-25 would require each registered clearing agency to establish, implement, maintain and enforce written policies and procedures reasonably designed to identify and address existing or potential conflicts of interest and that are reasonably designed to minimize conflicts of interest in decision-making at the clearing agency. The purpose of the collection of information is to enable the Commission to examine and evaluate a clearing agency's efforts to minimize conflicts and help to ensure the transparent, equitable operation of the clearing agency.

5. Standards for Board or Board Committee Directors

As discussed above, proposed Rule 17Ad-26 would require that a registered clearing agency establish certain governance standards applicable to its board or board committee members. The proposed collection of information is to help improve the effectiveness of a clearing agency's boards of directors.

6. Designation of Chief Compliance Officer

As discussed above, proposed Rule 3Cj-1 would require each registered clearing agency to designate a CCO who would establish and oversee the implementation of certain policies and procedures relating to non-compliance issues, as well as prepare, sign and submit an annual compliance report. The proposed collection of information should promote better compliance by clearing agencies with all applicable laws, regulations and policies.

C. Respondents

1. Standards in Proposed Rule 17Ad-22(b) that Impose a PRA Burden

The standards in proposed Rule 17Ad-22(b) that the Commission preliminarily believes impose a PRA burden are 17Ad-22(b)(1), (2), (3), (4), (5), (6) and (7). The requirements in proposed Rules 17Ad-22(b)(1), (2), (3), (4), (5), (6) and (7) would apply to all clearing agencies that perform central counterparty services. There are currently four clearing agencies authorized to provide CCP services for security-based swap transactions pursuant to the CDS Clearing Exemption Orders.[123] The Commission estimates, based on staff discussions with industry representatives, that there could conceivably be one or two more entities that clear security-based

[123] See supra note 6.

swaps in the future. Thus, the Commission estimates that four to six clearing agencies may seek to clear security-based swaps.[124] The Commission is using the higher estimate of six security-based swap clearing agencies for this PRA analysis. There are also eleven additional clearing agencies currently registered with the Commission,[125] of which only three are currently performing central counterparty services. Thus, for these provisions, the Commission estimates that there would be nine respondents.[126]

2. Standards in Proposed Rule 17Ad-22(c) that Impose a PRA Burden

The standards in proposed Rule 17Ad-22(c) that the Commission preliminarily believes impose a PRA burden are 17Ad-22(c)(1) and (2). The requirements of proposed Rule 17Ad-22(c)(1) would apply to all clearing agencies that perform CCP services. As noted above, there are currently four clearing agencies authorized to provide CCP services for security-based swap transactions pursuant to the CDS Clearing Exemption Orders,[127] and there could conceivably be one or two more entities that clear security-based swaps in the future. Thus, the Commission estimates that four to six clearing agencies may seek to clear security-based swaps.[128] The Commission is using the higher estimate of six respondent clearing agencies for this PRA

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124 The Commission preliminarily believes that there is a potential for new security-based swap clearing agencies to form but does not expect there to be a large number based on the significant level of capital and other financial resources needed for the formation of a clearing agency.

125 There are four clearing agencies with active operations currently registered with the Commission, plus seven registered clearing agencies that are inactive. Although the inactive entities may not be acting as clearing agencies, for purposes of the PRA the Commission is estimating 11 total clearing agencies.

126 This figure was calculated as follows: 6 clearing agencies providing CCP services for security-based swaps + 3 registered clearing agencies providing CCP services = 9 respondent clearing agencies.

127 See supra note 6.

128 See supra note 124 and accompanying text.

analysis. There are also eleven additional clearing agencies currently registered with the Commission,[129] of which only three are currently performing central counterparty services. Thus, for propose Rule 17Ad-22(c)(1), the Commission estimates that there would be nine respondents.[130]

The requirements of proposed Rule 17Ad-22(c)(2) would apply to all clearing agencies. Therefore, the Commission preliminarily believes that these PRA burdens would be imposed on all clearing agencies registered with the Commission. As noted above, there are currently four clearing agencies authorized to clear security-based swaps pursuant to the CDS Clearing Exemption Orders.[131] The Commission estimates, based on staff discussions with industry representatives, that there could conceivably be one or two more entities that clear security-based swaps in the future. Thus, the Commission estimates that four to six clearing agencies may seek to clear security-based swaps.[132] The Commission is using the higher estimate of six for the PRA analysis. There are also eleven additional clearing agencies currently registered with the Commission.[133] Thus, for proposed Rule 17Ad-22(c)(2), the Commission estimates that there would be seventeen respondents.[134]

3. Standards in Proposed Rule 17Ad-22(d) that Impose a PRA Burden

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129 See supra note 125.

130 See supra note 126.

131 See supra note 6.

132 See supra note 124 and accompanying text.

133 See supra note 125.

134 This figure was calculated as follows: 6 clearing agencies providing CCP services for security-based swaps + 11 additional registered clearing agencies = 17 respondent clearing agencies.

In proposed Rule 17Ad-22(d), the requirements that the Commission preliminarily believes impose a PRA burden are 17Ad-22(d)(1), (2), (3), (4), (5), (6), (7), (8), (9), (10), (11), (12), (13), (14) and (15). The Commission preliminarily believes that these PRA burdens would be imposed on all clearing agencies registered with the Commission. As noted above, there are currently four clearing agencies authorized to clear security-based swaps pursuant to the CDS Clearing Exemption Orders.[135] The Commission estimates based on staff discussions with industry representatives, that there could conceivably be one or two more entities that clear security-based swaps in the future. Thus, the Commission estimates that four to six clearing agencies may seek to clear security-based swaps.[136] The Commission is using the higher estimate of six for the PRA analysis. There are also eleven additional clearing agencies currently registered with the Commission.[137] Thus, for these provisions, the Commission estimates that there would be seventeen respondents.[138]

4. Dissemination of Pricing and Valuation Information by Security-Based Swap Clearing Agencies that Perform Central Counterparty Services

The requirements of proposed Rule 17Aj-1 to disseminate pricing and valuation information with respect to security-based swaps would apply to every security-based swap clearing agency that performs CCP services. As noted above, there are currently four entities providing CCP services for security-based swaps that are authorized to do so pursuant to the CDS Clearing Exemption Orders,[139] and there could conceivably be one or two more entities that

135 See supra note 6.

136 See supra note 124.

137 See supra note 125.

138 See supra note 134.

139 See supra note 6.

clear security-based swaps in the future. Thus, the Commission estimates that four to six clearing agencies that provide CCP services may seek to clear security-based swaps.[140] The Commission is using the higher estimate of six respondent clearing agencies for this PRA analysis.

5. Clearing Agency Policies and Procedures to Protect the Confidentiality of Trading Information of Clearing Agency Participants

The safeguards and procedures applicable to the confidential treatment of trading information received by a clearing agency under proposed Rule 17Ad-23 would apply to all clearing agencies registered with the Commission. As noted above, there are currently four clearing agencies authorized to clear security-based swaps pursuant to the CDS Clearing Exemption Orders,[141] and there could conceivably be one or two more entities that clear security-based swaps in the future. Thus, the Commission estimates that four to six clearing agencies may seek to clear security-based swaps.[142] The Commission is using the higher estimate of six respondent clearing agencies for this PRA analysis. There are also eleven additional clearing agencies currently registered with the Commission.[143] Thus, for this provision, the Commission estimates that there would be seventeen respondents.[144]

6. Clearing Agency Procedures to Identify and Address Conflicts of Interest

The conflicts of interest policies and procedures to be adopted by clearing agencies pursuant to proposed Rule 17Ad-25 would apply to all clearing agencies registered with the

140 See supra note 124 and accompanying text.

141 See supra note 6.

142 See supra note 124 and accompanying text.

143 See supra note 125.

144 See supra note 134.

Commission. As noted above, there are currently four clearing agencies authorized to clear security-based swaps pursuant to the CDS Clearing Exemption Orders,[145] and that there could conceivably be one or two more entities that clear security-based swaps in the future. Thus, the Commission estimates that four to six clearing agencies may seek to clear security-based swaps.[146] The Commission is using the higher estimate of six respondent clearing agencies for this PRA analysis. There are also eleven additional clearing agencies currently registered with the Commission.[147] Thus, for this provision, the Commission estimates that there would be seventeen respondents.[148]

7. Standards for Board or Board Committee Directors

The board and board committee directors governance standards to be established by clearing agencies pursuant to proposed Rule 17Ad-26 would apply to all clearing agencies registered with the Commission. As noted above, there are currently four clearing agencies authorized to clear security-based swaps pursuant to the CDS Clearing Exemption Orders,[149] and there could conceivably be one or two more entities that clear security-based swaps in the future. Thus, the Commission estimates that four to six clearing agencies may seek to clear security-based swaps.[150] The Commission is using the higher estimate of six respondent clearing agencies for this PRA analysis. There are also eleven additional clearing agencies currently

145 See supra note 6.

146 See supra note 124 and accompanying text.

147 See supra note 125.

148 See supra note 134.

149 See supra note 6.

150 See supra note 124 and accompanying text.

registered with the Commission.[151] Thus, for this provision, the Commission estimates that there would be seventeen respondents.[152]

8. Designation of Chief Compliance Officer

The provisions regarding CCOs of proposed Rule 3Cj-1 would apply to all clearing agencies registered with the Commission. As noted above, there are currently four clearing agencies authorized to clear security-based swaps pursuant to the CDS Clearing Exemption Orders,[153] and there could conceivably be one or two more entities that clear security-based swaps in the future. Thus, the Commission estimates that four to six clearing agencies may seek to clear security-based swaps.[154] The Commission is using the higher estimate of six respondent clearing agencies for this PRA analysis. There are also eleven additional clearing agencies currently registered with the Commission.[155] Thus, for this provision, the Commission estimates that there would be seventeen respondents.[156]

D. Total Annual Reporting and Recordkeeping Burden

1. Standards for Clearing Agencies Reporting Requirements

a. Measurement and Management of Credit Exposures

Proposed Rule 17Ad-22(b)(1) would require a clearing agency that provides CCP services to establish, implement, maintain and enforce written policies and procedures reasonably designed to measure its credit exposures to its participants at least once a day and limit its exposures to potential losses from defaults by its participants in normal market

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151 See supra note 125.

152 See supra note 134.

153 See supra note 6.

154 See supra note 124 and accompanying text.

155 See supra note 125.

156 See supra note 134.

conditions so that the operations of the clearing agency would not be disrupted and non-defaulting participants would not be exposed to losses that they cannot anticipate or control. The exact nature of any rules and procedures a clearing agency would likely establish to support this requirement is likely to vary between clearing agencies. However, there are estimates of the burden imposed by similar policies and procedures requirements in Regulation NMS and in proposed requirements for security-based swap data repositories ("SDRs").[157] Specifically, Rule 611 of Regulation NMS, referred to as the "Order Protection Rule", requires trading centers to establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent trade-throughs on that trading center of protected quotations in NMS stocks, unless an exception applies.[158] While the requirements underlying those estimates are not identical to this requirement for clearing agencies, the Commission preliminarily believes that for PRA purposes the requirement for policies and procedures to be created and maintained by SRO and non-SRO trading centers in Rule 611 of Regulation NMS is similar in nature and scope to this requirement for clearing agencies to create policies and procedures.

Accordingly, the Commission believes that the burdens imposed on respondents to create policies and procedures in both contexts would be roughly equivalent. In its adoption of the final Order Protection Rule, the Commission estimated the approximate hourly burdens imposed on trading centers that are SROs and on trading centers that are not SROs to establish written policies and procedures that are reasonably designed to prevent execution of trade throughs. For

157 See Exchange Act Release Nos. 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005) (discussing in Section VIII.A.4. the time needed from legal, compliance, information technology and business operations personnel to create policies and procedures for preventing and monitoring trade-throughs) and 63347 (November 19, 2010), 75 FR 77306 (December 10, 2010) (discussing in Section V.D.7. the time needed for SDRs to establish and enforce written policies and procedures reasonably designed to minimize conflicts of interest).

158 See 17 CFR 242.611.

SRO trading centers, the Commission estimated that creating written policies and procedures would require approximately 270 hours and require efforts from the various skill sets of the clearing agency's legal, compliance, information technology and business operations personnel. For non-SRO trading centers, the Commission estimated an approximate hourly burden of 210 hours to meet the same requirement. This difference between the hourly burden imposed on non-SRO trading centers and SRO trading centers is primarily due to a slightly lower expectation for the hourly burden imposed on the legal and compliance staff at a non-SRO trading center.

The Commission preliminarily believes that this hourly burden estimate of 210 hours for non-SRO trading centers under Regulation NMS is an appropriate estimate for the burden that would be imposed on clearing agencies to create policies and procedures because, as discussed below, recent assessments of the registered U.S. clearing agencies support the conclusion that clearing agencies and their rule books generally meet or exceed analogous standards of operation and governance to those standards within proposed Rule 17Ad-22.[159] Therefore, those findings and the Commission's experience in oversight of clearing agencies support a preliminary view that the requirements in the rules for clearing agencies proposed by the Commission would in many cases impose a burden on legal and compliance personnel at clearing agencies that would involve adjustments to a registered clearing agency's rule book and its policies and procedures rather than creation of entirely separate policies and procedures to support entirely new operations and practices.

Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and in the proposed requirements for security-based swap data repositories, the Commission preliminarily estimates that proposed Rule 17Ad-22(b)(1)

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159 See infra note 291.

would impose a one-time burden on each respondent clearing agency of 210 hours, corresponding to an aggregate one-time burden on all respondent clearing agencies of 1,890 hours.[160] The Commission solicits comment regarding the accuracy of this estimate.

Clearing agencies that provide CCP services would be required to measure their credit exposures as required by proposed Rule 17Ad-22(b)(1) on an ongoing basis. The Commission expects that the exact burden of administering the procedures for monitoring custody and investment standards would vary depending on how frequently each clearing agency may need to update its procedures. Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and for security-based swap data repositories, the Commission estimates that the ongoing requirements of this rule would impose an aggregate annual burden of 60 hours on each respondent clearing agency, corresponding to an aggregate annual burden for all respondent clearing agencies of 540 hours.[161] The Commission solicits comment regarding the accuracy of this estimate.

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160 This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) + (Senior Business Analyst at 23 hours)) = 210 hours x 9 respondent clearing agencies = 1,890 hours. See Exchange Act Release Nos. 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005) (Section VIII.A.4. finding a burden of 210 hours needed for non-SRO trading centers to create one policy and procedure) and 63347 (November 19, 2010), 75 FR 77306 (December 10, 2010) (Section V.D.7. finding a burden of 210 hours needed for an SDR to create one policy and procedure).

The Commission based these estimates on the estimates for non-SRO trading centers that appear in Exchange Act Release Nos. 51808 and 63347 because the Commission preliminarily believes that the existing clearing agency requirements under Section 17A of the Exchange Act make these proposed burdens more similar to the less burdensome requirements for non-SRO trading centers than the burdens for SRO trading centers

161 This figure was calculated as follows: Compliance Attorney at 60 hours x 9 respondent clearing agencies = 540 hours for all respondent clearing agencies. See Exchange Act Release Nos. 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005) (Section VIII.A.4. estimating that it would take the average SRO and non-SRO trading center approximately two hours per month of internal legal time and three hours of internal compliance time to ensure that its written policies and procedures are up-to-date and remain in compliance

b. Margin Requirements

Proposed Rule 17Ad-22(b)(2) would require a clearing agency that provides CCP services to establish, implement, maintain and enforce written policies and procedures reasonably designed to use margin requirements to limit its credit exposures to participants in normal market conditions and use risk-based models and parameters to set margin requirements and review them at least monthly. The exact nature of any rules and procedures a clearing agency would likely establish to support this requirement is likely to vary between clearing agencies. However, there are estimates of the burden imposed by similar policies and procedures requirements in Regulation NMS and in proposed requirements for security-based swap data repositories.[162] While the requirements underlying those estimates are not identical to this requirement for clearing agencies, the Commission preliminarily believes that for PRA purposes there is similarity in the burden to create policies and procedures.

Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and in the proposed requirements for security-based swap data repositories, the Commission preliminarily estimates that proposed Rule 17Ad-22(b)(2) would impose a one-time burden on each respondent clearing agency of 210 hours, corresponding to an aggregate one-time burden on all respondent clearing agencies of 1,890 hours.[163] The Commission solicits comment regarding the accuracy of this estimate.

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amounting to an annual burden of 60 hours per year per respondent) and 63347 (November 19, 2010), 75 FR 77306 (December 10, 2010) (Section V.D.7. estimating the time needed for SDRs to establish and enforce written policies and procedures).

162 See supra note 157.

163 This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) + (Senior Business Analyst at 23 hours)) = 210 hours x 9 respondent clearing agencies = 1,890 hours. See supra note 160.

Clearing agencies would be required to administer their custody and investment standards required by proposed Rule 17Ad-22(b)(2) on an ongoing basis. The Commission expects that the exact burden of administering the procedures for monitoring custody and investment standards would vary depending on how frequently each clearing agency may need to update its procedures. Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and for security-based swap data repositories, the Commission estimates that the ongoing requirements of this rule would impose an aggregate annual burden of 60 hours on each respondent clearing agency, corresponding to an aggregate annual burden for all respondent clearing agencies of 540 hours.[164] The Commission solicits comment regarding the accuracy of this estimate.

c. Financial Resources

Proposed Rule 17Ad-22(b)(3) would require a clearing agency that provides CCP services to establish, implement, maintain and enforce written policies and procedures reasonably designed to maintain sufficient financial resources to withstand, at a minimum, a default by the participant to which it has the largest exposure in extreme but plausible market conditions, and if the clearing agency provides CCP services for security-based swaps then a default by the two participants to which it has the largest exposures in extreme but plausible market conditions; provided that if a participant controls another participant or is under common control with another participant, the affiliated participant and the participant shall be deemed to be a single participant. The exact nature of any rules and procedures a clearing agency would likely establish to support this requirement is likely to vary between clearing agencies. However, there are estimates of the burden imposed by similar policies and procedures requirements in

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164 This figure was calculated as follows: Compliance Attorney at 60 hours x 9 respondent clearing agencies = 540 hours for all respondent clearing agencies. See supra note 161.

Regulation NMS and in proposed requirements for security-based swap data repositories.[165] While the requirements underlying those estimates are not identical to this requirement for clearing agencies, the Commission preliminarily believes that for PRA purposes there is similarity in the burden to create policies and procedures.

Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and in the proposed requirements for security-based swap data repositories, the Commission preliminarily estimates that proposed Rule 17Ad-22(b)(3) would impose a one-time burden on each respondent clearing agency of 210 hours, corresponding to an aggregate one-time burden on all respondent clearing agencies of 1,890 hours.[166] The Commission solicits comment regarding the accuracy of this estimate.

Clearing agencies would be required to administer their financial resources standards required by proposed Rule 17Ad-22(b)(3) on an ongoing basis. The Commission expects that the exact burden of administering the procedures for financial resources standards would vary depending on how frequently each clearing agency may need to update its procedures. Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and for security-based swap data repositories, the Commission estimates that the ongoing requirements of this rule would impose an aggregate annual burden of 60 hours on each respondent clearing agency, corresponding to an aggregate annual burden for all respondent

165 See supra note 157.

166 This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) + (Senior Business Analyst at 23 hours)) = 210 hours x 9 respondent clearing agencies = 1,890 hours. See supra note 160.

clearing agencies of 540 hours.[167] The Commission solicits comment regarding the accuracy of this estimate.

d. Model Validation

As discussed above, proposed Rule 17Ad-22(b)(4) would require a clearing agency that provides CCP services to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide for an annual model validation. The Commission preliminarily believes this requirement would help to ensure that a clearing agency's margin model remains effective in determining the appropriate margin level. The exact nature of any rules and procedures a clearing agency would likely establish to support this requirement is likely to vary between clearing agencies. However, there are estimates of the burden imposed by similar policies and procedures requirements in Regulation NMS and in proposed requirements for security-based swap data repositories.[168] While the requirements underlying those estimates are not identical to this requirement for clearing agencies, the Commission preliminarily believes that for PRA purposes there is similarity in the burden to create policies and procedures.

Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and in the proposed requirements for security-based swap data repositories, the Commission preliminarily estimates that proposed Rule 17Ad-22(b)(4) would impose a one-time burden on each respondent clearing agency of 210 hours,

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167 This figure was calculated as follows: Compliance Attorney at 60 hours x 9 respondent clearing agencies = 540 hours for all respondent clearing agencies. See supra note 161.

168 See supra note 157.

corresponding to an aggregate one-time burden on all respondent clearing agencies of 1,890 hours.[169] The Commission solicits comment regarding the accuracy of this estimate.

Clearing agencies would be required to administer their model validation standards required by proposed Rule 17Ad-22(b)(4) on an ongoing basis. The Commission expects that the exact burden of administering the procedures for model validation standards would vary depending on how frequently each clearing agency may need to update its procedures. Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and for security-based swap data repositories, the Commission estimates that the ongoing requirements of this rule would impose an aggregate annual burden of 60 hours on each respondent clearing agency, corresponding to an aggregate annual burden for all respondent clearing agencies of 540 hours.[170] The Commission solicits comment regarding the accuracy of this estimate.

Based on its oversight of clearing agencies, the Commission preliminarily estimates that proposed Rule 17Ad-22(b)(4) would impose an annual burden on all respondent clearing agencies of 6,480 hours.[171] The Commission solicits comment regarding the accuracy of this estimate.

e. Non-Dealer Access

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169 This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) + (Senior Business Analyst at 23 hours)) = 210 hours x 9 respondent clearing agencies = 1,890 hours. See supra note 160.

170 This figure was calculated as follows: Compliance Attorney at 60 hours x 9 respondent clearing agencies = 540 hours for all respondent clearing agencies. See supra note 161.

171 This figure was calculated as follows: Consultant at 30 hours per week x 12 weeks x 2 Consultants x 9 respondent clearing agencies = 6,480 hours.

Proposed Rule 17Ad-22(b)(5) would require a clearing agency that provides CCP services to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide the opportunity for a person that does not perform any dealer or security-based swap dealer services to obtain membership at the clearing agency to clear securities for itself or on behalf of other persons. The exact nature of the procedures a clearing agency would establish to support this requirement is likely to vary between clearing agencies. However, there are estimates of the burden imposed by similar policies and procedures requirements in Regulation NMS and in proposed requirements for security-based swap data repositories.[172] While the requirements underlying those estimates are not identical to this requirement for clearing agencies, the Commission preliminarily believes that for PRA purposes there is similarity in the burden to create policies and procedures.

Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and in the proposed requirements for security-based swap data repositories, the Commission preliminarily estimates that proposed Rule 17Ad-22(b)(5) would impose a one-time burden on each respondent clearing agency of 210 hours, corresponding to an aggregate one-time burden on all respondent clearing agencies of 1,890 hours.[173] The Commission solicits comment regarding the accuracy of this estimate.

Clearing agencies would be required to administer their membership standards required by proposed Rule 17Ad-22(b)(5) on an ongoing basis. The Commission expects that the exact burden of administering the procedures for granting membership to persons that do not perform

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[172] See supra note 157.

[173] This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) + (Senior Business Analyst at 23 hours)) = 210 hours x 9 respondent clearing agencies = 1,890 hours. See supra note 160.

any dealer or security-based swap dealer services would vary depending on how frequently each clearing agency may need to update its procedures. Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and for security-based swap data repositories, the Commission estimates that the ongoing requirements of this rule would impose an aggregate annual burden of 60 hours on each respondent clearing agency, corresponding to an aggregate annual burden for all respondent clearing agencies of 540 hours.[174] The Commission solicits comment regarding the accuracy of this estimate.

f. Portfolio Size and Transaction Volume Thresholds Restrictions

Proposed Rule 17Ad-22(b)(6) would require a clearing agency that provides CCP services to establish, implement, maintain and enforce written policies and procedures reasonably designed to have membership standards that do not require that participants maintain a portfolio of any minimum size or that participants maintain a minimum transaction volume. The exact nature of the procedures a clearing agency would establish to support this requirement is likely to vary between clearing agencies. However, there are estimates of the burden imposed by similar policies and procedures requirements in Regulation NMS and in proposed requirements for security-based swap data repositories.[175] While the requirements underlying those estimates are not identical to this requirement for clearing agencies, the Commission preliminarily believes that for PRA purposes there is similarity in the burden to create policies and procedures.

Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and in the proposed requirements for security-based swap

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174 This figure was calculated as follows: Compliance Attorney at 60 hours x 9 respondent clearing agencies = 540 hours for all respondent clearing agencies. See supra note 161.

175 See supra note 157.

data repositories, the Commission preliminarily estimates that proposed Rule 17Ad-22(b)(6) would impose a one-time burden on each respondent clearing agency of 210 hours, corresponding to an aggregate one-time burden on all respondent clearing agencies of 1,890 hours.[176] The Commission solicits comment regarding the accuracy of this estimate.

Clearing agencies would be required to administer their membership standards required by proposed Rule 17Ad-22(b)(6) on an ongoing basis. The Commission expects that the exact burden of administering the procedures for not having membership standards that require participants to maintain a portfolio of any minimum size or that participants maintain a minimum transaction volume would vary depending on how frequently each clearing agency may need to update its procedures. Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and for security-based swap data repositories, the Commission estimates that the ongoing requirements of this rule would impose an aggregate annual burden of 60 hours on each respondent clearing agency, corresponding to an aggregate annual burden for all respondent clearing agencies of 540 hours.[177] The Commission solicits comment regarding the accuracy of this estimate.

g. Net Capital Requirements

Proposed Rule 17Ad-22(b)(7) would require a clearing agency that provides CCP services to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide a person that maintains a net capital equal to or greater than $50 million with the ability to obtain membership at the clearing agency, with any net capital

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176 This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) + (Senior Business Analyst at 23 hours)) = 210 hours x 9 respondent clearing agencies = 1,890 hours. See supra note 160.

177 This figure was calculated as follows: Compliance Attorney at 60 hours x 9 respondent clearing agencies = 540 hours for all respondent clearing agencies. See supra note 161.

requirements being scalable so that they are proportional to the risks posed by the participant's activities to the clearing agency. The exact nature of the procedures a clearing agency would establish to support this requirement is likely to vary between clearing agencies. However, there are estimates of the burden imposed by similar policies and procedures requirements in Regulation NMS and in proposed requirements for security-based swap data repositories.[178] While the requirements underlying those estimates are not identical to this requirement for clearing agencies, the Commission preliminarily believes that for PRA purposes there is similarity in the burden to create policies and procedures.

Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and in the proposed requirements for security-based swap data repositories, the Commission preliminarily estimates that proposed Rule 17Ad-22(b)(7) would impose a one-time burden on each respondent clearing agency of 210 hours, corresponding to an aggregate one-time burden on all respondent clearing agencies of 1,890 hours.[179] The Commission solicits comment regarding the accuracy of this estimate.

Clearing agencies may need to update these policies and procedures over time, particularly due to the fact that proposed Rule 17Ad-22(b)(7) permits a clearing agency to provide for a higher net capital requirement (i.e., higher than $50 million) as a condition for membership at the clearing agency if the clearing agency demonstrates to the Commission that such a requirement is necessary to mitigate risks that could not otherwise be effectively managed by other measures, such as scalable limitations on the transactions that the participants may clear

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178 See supra note 157.

179 This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) + (Senior Business Analyst at 23 hours)) = 210 hours x nine respondent clearing agencies = 1,890 hours. See supra note 160.

through the clearing agency, and the Commission approves the higher net capital requirement as part of a rule filing or clearing agency registration application. While the number of times each clearing agency will need to update its policies and procedures to revise its net capital requirements is likely to vary, both over time and between clearing agencies, such changes may occur as a result of an annual review of a clearing agency's operations and default mechanisms. For the same reasons as discussed above, the Commission believes that the estimates of the burden imposed by the policies and procedures requirements in Regulation NMS and in proposed requirements for security-based swap data repositories[180] are sufficiently similar to serve as a basis for these estimates. Accordingly, the Commission preliminarily estimates that proposed Rule 17Ad-22(b)(7) would impose an annual burden on each respondent clearing agency of 210 hours, corresponding to an aggregate annual burden on all respondent clearing agencies of 1,890 hours.[181] The Commission solicits comment regarding the accuracy of this estimate.

Clearing agencies that provide CCP services would be required to administer their net capital requirements required by proposed Rule 17Ad-22(b)(7) on an ongoing basis. The Commission expects that the exact burden of administering the net capital requirements would vary depending on how frequently each clearing agency providing CCP services may need to update its procedures. Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and for security-based swap data repositories, the Commission estimates that the ongoing requirements of this rule would impose

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180 See supra note 157.

181 This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) + (Senior Business Analyst at 23 hours)) = 210 hours x nine respondent clearing agencies = 1,890 hours. See supra note 160.

an aggregate annual burden of 60 hours on each respondent clearing agency, corresponding to an aggregate annual burden for all respondent clearing agencies of 540 hours.[182] The Commission solicits comment regarding the accuracy of this estimate.

h. Record of Financial Resources

As detailed above, pursuant to proposed Rule 17Ad-22(c)(1), clearing agencies that perform central counterparty services would be required each fiscal quarter (based on calculations made as of the last business day of the clearing agency's fiscal quarter), or at any time upon Commission request, to calculate and maintain a record of the financial resources necessary to meet the requirement in proposed Rule 17Ad-22(c)(1) and sufficient documentation to explain the methodology it uses to compute such financial resource requirement.

The exact nature of the procedures a clearing agency would establish to support this requirement is likely to vary between clearing agencies. However, there are estimates of the burden imposed by similar policies and procedures requirements in Regulation NMS and in proposed requirements for security-based swap data repositories.[183] While the requirements underlying those estimates are not identical to this requirement for clearing agencies, the Commission preliminarily believes that for PRA purposes there is similarity in the burden to create policies and procedures.

Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and in the proposed requirements for security-based swap data repositories, the Commission preliminarily estimates that proposed Rule 17Ad-22(c)(1) would impose a one-time burden on each respondent clearing agency of 210 hours,

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182 This figure was calculated as follows: Compliance Attorney at 60 hours x 9 respondent clearing agencies = 540 hours for all respondent clearing agencies. See supra note 161.

183 See supra note 157.

corresponding to an aggregate one-time burden on all respondent clearing agencies of 1,890 hours.[184] The Commission solicits comment regarding the accuracy of this estimate.

Based on its oversight of clearing agencies, the Commission believes that the respondent clearing agencies already have methodologies designed to ensure that in providing CCP services the clearing agency can withstand a default by the participant to which the clearing agency has the largest exposure in extreme but plausible market conditions.[185] Because clearing agencies that provide CCP services already use such methodologies, the Commission preliminarily believes the one-time burden imposed would involve adjustments needed to synthesize and format existing information in a manner sufficient to explain the methodology the clearing agency uses to meet the requirement of proposed Rule 17Ad-22(c)(1). The Commission preliminarily believes these adjustments would impose a one-time burden of 100 hours on each clearing agency, corresponding to an aggregate one-time burden imposed on all clearing agencies of 900 hours.[186] The Commission solicits comment regarding the accuracy of this estimate.

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[184] This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) + (Senior Business Analyst at 23 hours)) = 210 hours x 9 respondent clearing agencies = 1,890 hours. See supra note 160.

[185] See, e.g., International Monetary Fund, Publication of Financial Sector Assessment Program Documentation – Detailed Assessment of Observance of the National Securities Clearing Corporation's Observance of the CPSS-IOSCO Recommendations for Central Counterparties, 10 (2010) (assessing National Securities Clearing Corporation's observance of Recommendation 5 from the RCCP that a CCP should maintain sufficient financial resources to withstand, at a minimum, the default of a participant to which it has the largest exposure in extreme but plausible market conditions and noting that NSCC began evaluating itself against this standard in 2009 and has back-testing results to support that during the period from January through April 2009 there was sufficient liquidity to cover the needs of the failure of the largest affiliated family 99.98 percent of the time), available at http://www.imf.org/external/pubs/ft/scr/2010/cr10129.pdf.

[186] This figure was calculated as follows: ((Chief Compliance Officer at 40 hours) + (Computer Operations Department Manager at 40 hours) + (Senior Programmer at 20

On an ongoing basis, the Commission estimates that for a clearing agency to generate the required reports concerning its financial resources would impose a burden of three hours per respondent clearing agency per quarter. This amounts to an annual burden of 12 hours for each clearing agency and corresponds to an aggregate annual burden of 108 hours for all respondent clearing agencies.[187] The Commission solicits comment regarding the accuracy of this estimate.

Clearing agencies providing CCP services would also be required to administer any procedures used to support compliance with Rule 17Ad-22(c)(1) on an ongoing basis. The Commission expects that the exact burden of administering the procedures for granting membership to persons that do not perform any dealer or security-based swap dealer services would vary depending on how frequently each clearing agency may need to update its procedures. Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and for security-based swap data repositories, the Commission estimates that the ongoing requirements of this rule would impose an aggregate annual burden of 60 hours on each respondent clearing agency, corresponding to an aggregate annual burden for all respondent clearing agencies of 540 hours.[188] The Commission solicits comment regarding the accuracy of this estimate.

i. Annual Audited Financial Report

Proposed Rule 17Ad-22(c)(2) would also require that a clearing agency post on its website an annual financial report. Each financial report shall (i) be a complete set of financial

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hours)) = 100 hours x 9 respondent clearing agencies = 900 hours. See infra note 253 and accompanying text.

187 This figure was calculated as follows: ((Compliance Attorney at 1 hour) + (Computer Operations Department Manager at 2 hours)) = 3 hours per quarter x 4 quarters per year = 12 hours per year x 9 respondent clearing agencies = 108 hours.

188 This figure was calculated as follows: Compliance Attorney at 60 hours x 9 respondent clearing agencies = 540 hours for all respondent clearing agencies. See supra note 161.

statements of the clearing agency for the most recent two fiscal years and be prepared in accordance with U.S. GAAP, except that for a clearing agency that is a corporation or other organization incorporated or organized under the laws of any foreign country the financial statements may be prepared according to U.S. GAAP or IFRS; (ii) be audited in accordance with standards of the Public Company Accounting Oversight Board by a registered public accounting firm that is qualified and independent in accordance with Rule 2-01 of Regulation S-X; and (iii) include report of the registered public accounting firm that complies with paragraphs (a) through (d) of Rule 2-02 of Regulation S-X.

The exact nature of the procedures a clearing agency would establish to support this requirement is likely to vary between clearing agencies. However, there are estimates of the burden imposed by similar policies and procedures requirements in Regulation NMS and in proposed requirements for security-based swap data repositories.[189] While the requirements underlying those estimates are not identical to this requirement for clearing agencies, the Commission preliminarily believes that for PRA purposes there is similarity in the burden to create policies and procedures.

Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and in the proposed requirements for security-based swap data repositories, the Commission preliminarily estimates that proposed Rule 17Ad-22(c)(2) would impose a one-time burden on each respondent clearing agency of 210 hours, corresponding to an aggregate one-time burden on all respondent clearing agencies of 3,570 hours.[190] The Commission solicits comment regarding the accuracy of this estimate.

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189 See supra note 157.

190 This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) +

The Commission preliminarily believes, based on its oversight of clearing agencies, that the one-time burden imposed by the rule would involve systems adjustments at the clearing agency needed to facilitate posting of the annual audited financial report to the clearing agency's website. The Commission preliminarily believes these adjustments would impose a one-time burden of 100 hours on each clearing agency, corresponding to an aggregate one-time burden imposed on all clearing agencies of 1,700 hours.[191] The Commission solicits comment regarding the accuracy of this estimate.

On an ongoing basis, clearing agencies would be required to administer any policies and procedures used to support compliance with Rule 17Ad-22(c)(2). The Commission expects that the exact burden of administering the procedures for facilitating an annual audit report of the clearing agency and posting that annual audit report to the clearing agency's website would vary. However, based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and for security-based swap data repositories, the Commission estimates that the ongoing requirements of this rule would impose an aggregate annual burden of 60 hours on each respondent clearing agency, corresponding to an aggregate annual burden for all respondent clearing agencies of 1,020 hours.[192] The Commission solicits comment regarding the accuracy of this estimate.

The Commission estimates based on its experience with entities of similar size to the

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(Senior Business Analyst at 23 hours)) = 210 hours x 17 respondent clearing agencies = 3,570 hours. See supra note 160.

191 This figure was calculated as follows: ((Chief Compliance Officer at 40 hours) + (Computer Operations Department Manager at 40 hours) + (Senior Programmer at 20 hours)) = 100 hours x 9 respondent clearing agencies = 900 hours. See infra note 253 and accompanying text.

192 This figure was calculated as follows: Compliance Attorney at 60 hours x 17 respondent clearing agencies = 1,020 hours for all respondent clearing agencies. See supra note 161.

respondents to this collection, that these reports would generally require on average 500 hours annually per respondent clearing agency to generate and cost $500,000 for independent public accounting services. Thus, the Commission preliminarily believes this corresponds to an aggregate annual burden to all clearing agencies of 8,500 hours and $8,500,000.[193] The Commission solicits comment as to the accuracy of this estimate.

j. Transparent and Enforceable Rules and Procedures

Proposed Rule 17Ad-22(d)(1) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide for a well founded, transparent and enforceable legal framework. The exact nature of the policies and procedures a clearing agency would establish is likely to vary between clearing agencies. However, there are estimates of the burden imposed by similar policies and procedures requirements in Regulation NMS and in proposed requirements for SDRs.[194] Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and in the proposed requirements for security-based swap data repositories, the Commission preliminarily estimates that proposed Rule 17Ad-22(d)(1) would impose a one-time burden on each respondent clearing agency of 210 hours, corresponding to an aggregate one-time burden on all respondent clearing agencies of 3,570 hours.[195] The Commission solicits comment regarding the accuracy of this estimate.

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193 See Exchange Act Release No. 63347 (November 19, 2010), 75 FR 77306 (December 10, 2010) (Section VI.F.2. discussing the time the Commission preliminarily estimates an SDR would need to prepare and file annual financial reports with the Commission pursuant to proposed Rule 13n-11(f) and (g)). This figure was calculated as follows: Senior Accountant at 500 hours x 17 respondent clearing agencies = 8,500 hours.

194 See supra note 157.

195 This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) +

Clearing agencies would be required to administer their rules and procedures to ensure they provide for a well founded, transparent and enforceable legal framework on an ongoing basis. The Commission expects that the exact burden of administering the procedures for monitoring participation standards would vary depending on how frequently each clearing agency may need to update its rules and procedures. Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and for security-based swap data repositories, the Commission estimates that the ongoing requirements of this rule would impose an aggregate annual burden of 60 hours on each respondent clearing agency, corresponding to an aggregate annual burden for all respondent clearing agencies of 1,020 hours.[196] The Commission solicits comment regarding the accuracy of this estimate.

k. Participation Requirements

Proposed Rule 17Ad-22(d)(2) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to have procedures in place to monitor that their participation requirements are met on an ongoing basis. The exact nature of the procedures a clearing agency would establish is likely to vary between clearing agencies. However, there are estimates of the burden imposed by similar policies and procedures requirements in Regulation NMS and in proposed requirements for security-based swap data repositories.[197] While the requirements underlying those estimates are not identical to this requirement for clearing agencies, the Commission preliminarily believes that for PRA purposes there is similarity in the burden to create policies and procedures.

(Senior Business Analyst at 23 hours) = 210 hours x 17 respondent clearing agencies = 3,570 hours.

196 This figure was calculated as follows: Compliance Attorney at 60 hours x 17 respondent clearing agencies = 1,020 hours.

197 See supra note 157.

Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and in the proposed requirements for security-based swap data repositories, the Commission preliminarily estimates that proposed Rule 17Ad-22(d)(2) would impose a one-time burden on each respondent clearing agency of 210 hours, corresponding to an aggregate one-time burden on all respondent clearing agencies of 3,570 hours.[198] The Commission solicits comment regarding the accuracy of this estimate.

Clearing agencies would be required to administer their participation requirements required by proposed Rule 17Ad-22(d)(2) on an ongoing basis. The Commission expects that the exact burden of administering the procedures for monitoring participation requirements would vary depending on how frequently each clearing agency may need to update its procedures. Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and for security-based swap data repositories, the Commission estimates that the ongoing requirements of this rule would impose an aggregate annual burden of 60 hours on each respondent clearing agency, corresponding to an aggregate annual burden for all respondent clearing agencies of 1,020 hours.[199] The Commission solicits comment regarding the accuracy of this estimate.

Additionally, proposed Rule 17Ad-22(d)(2) would require clearing agencies to publicly disclose their participation requirements. Based on staff discussions with respondents that are already subject to a similar requirement in the CDS Clearing Exemption Orders to make publicly

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198 This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) + (Senior Business Analyst at 23 hours)) = 210 hours x 17 respondent clearing agencies = 3,570 hours. See supra note 195.

199 This figure was calculated as follows: Compliance Attorney at 60 hours x 17 respondent clearing agencies = 1,020 hours. See supra note 196.

available certain pricing and valuation information for security-based swaps,[200] the Commission estimates that the one-time burden for a security-based swap clearing agency to comply with the requirements of proposed Rule 17Ad-22(d)(2) would involve slight adjustments to computer data systems that would already be in place as part of its clearing agency operations under Exchange Act Section 17A. The Commission preliminarily believes that a similar analysis would apply to each of the other registered clearing agencies. Therefore, the Commission does not anticipate that new hardware, such as additional computer equipment, would be required. Instead, the Commission broadly estimates that a clearing agency's adjustments to its systems to meet the requirements of proposed Rule 17Ad-22(d)(2) would impose a one-time burden of 100 hours on each respondent clearing agency, corresponding to an aggregate one-time burden imposed on all respondent clearing agencies of 1,700 hours.[201] The Commission solicits comment regarding the accuracy of this estimate.

Respondent clearing agencies would also have an ongoing responsibility to make their participation requirements available. Also based on staff discussion with respondents that are already subject to the requirement in the CDS Clearing Exemption Orders to make certain pricing and valuation information publicly available, the Commission preliminarily believes that the ongoing burden would be limited and would likely involve maintenance and troubleshooting of computer systems used to facilitate dissemination of participant requirements. Therefore, the Commission preliminarily estimates this would impose an annual aggregate burden of 60 hours for each respondent clearing agency, which corresponds to an ongoing aggregate annual burden

200 See infra notes 251 –254 and accompanying text.

201 This figure was calculated as follows: ((Chief Compliance Officer at 40 hours) + (Computer Operations Department Manager at 40 hours) + (Senior Programmer at 20 hours)) = 100 hours x 17 respondent clearing agencies = 1,700 hours. See infra note 253 and accompanying text.

of 1,020 hours for all respondent clearing agencies.[202] The Commission solicits comment regarding the accuracy of this estimate.

l. Identification and Mitigation of Custody of Assets and Investment Risk

Proposed Rule 17Ad-22(d)(3) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to hold assets in a manner that minimizes risk of loss or delay in access to them, and to invest assets in instruments with minimal credit, market, and liquidity risks. The exact nature of any rules and procedures a clearing agency would likely establish to support this requirement is likely to vary between clearing agencies. However, there are estimates of the burden imposed by similar policies and procedures requirements in Regulation NMS and in proposed requirements for security-based swap data repositories.[203] While the requirements underlying those estimates are not identical to this requirement for clearing agencies, the Commission preliminarily believes that for PRA purposes there is similarity in the burden to create policies and procedures.

Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and in the proposed requirements for security-based swap data repositories, the Commission preliminarily estimates that proposed Rule 17Ad-22(d)(3) would impose a one-time burden on each respondent clearing agency of 210 hours, corresponding to an aggregate one-time burden on all respondent clearing agencies of 3,570 hours.[204] The Commission solicits comment regarding the accuracy of this estimate.

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202 This figure was calculated as follows: Computer Operations Department Manager at 60 hours annually x 17 respondent clearing agencies = 1,020 hours for all respondent clearing agencies. <u>See</u> <u>supra</u> note 196.

203 <u>See</u> <u>supra</u> note 157.

204 This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) +

Clearing agencies would be required to administer their custody and investment standards required by proposed Rule 17Ad-22(d)(3) on an ongoing basis. The Commission expects that the exact burden of administering the procedures for monitoring custody and investment standards would vary depending on how frequently each clearing agency may need to update its procedures. Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and for security-based swap data repositories, the Commission estimates that the ongoing requirements of this rule would impose an aggregate annual burden of 60 hours on each respondent clearing agency, corresponding to an aggregate annual burden for all respondent clearing agencies of 1,020 hours.[205] The Commission solicits comment regarding the accuracy of this estimate.

m. Identification and Mitigation of Operational Risk

Proposed Rule 17Ad-22(d)(4) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to identify and have procedures in place, including business continuity plans, to minimize sources of operational risk. The exact nature of the procedures a clearing agency would establish is likely to vary between clearing agencies. However, there are estimates of the burden imposed by similar policies and procedures requirements in Regulation NMS and in proposed requirements for security-based swap data repositories.[206] While the requirements underlying those estimates are not identical to this requirement for clearing agencies, the Commission preliminarily believes that for PRA purposes there is similarity in the burden to create policies and procedures.

(Senior Business Analyst at 23 hours)) = 210 hours x 17 respondent clearing agencies = 3,570 hours. See supra note 195.

205 This figure was calculated as follows: Compliance Attorney at 60 hours x 17 respondent clearing agencies = 1,020 hours for all respondent clearing agencies. See supra note 196.

206 See supra note 157.

Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and in the proposed requirements for security-based swap data repositories, the Commission preliminarily estimates that proposed Rule 17Ad-22(d)(4) would impose a one-time burden on each respondent clearing agency of 210 hours, corresponding to an aggregate one-time burden on all respondent clearing agencies of 3,570 hours.[207] The Commission solicits comment regarding the accuracy of this estimate.

Clearing agencies would be required to administer their operational standards required by proposed Rule 17Ad-22(d)(4) on an ongoing basis. The Commission expects that the exact burden of administering the procedures for monitoring operational risks would vary depending on how frequently each clearing agency may need to update its procedures. Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and for security-based swap data repositories, the Commission estimates that the ongoing requirements of this rule would impose an aggregate annual burden of 60 hours on each respondent clearing agency, corresponding to an aggregate annual burden for all respondent clearing agencies of 1,020 hours.[208] The Commission solicits comment regarding the accuracy of this estimate.

n. Money Settlement Risks

Proposed Rule 17Ad-22(d)(5) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to employ money settlement arrangements that eliminate or strictly limit the clearing agency's settlement bank

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207 This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) + (Senior Business Analyst at 23 hours)) = 210 hours x 17 respondent clearing agencies = 3,570 hours. See supra note 195.

208 This figure was calculated as follows: Compliance Attorney at 60 hours x 17 respondent clearing agencies = 1,020 hours for all respondent clearing agencies. See supra note 196.

risks, that is, its credit and liquidity risks from the use of banks to effect money settlements with its participants; and require funds transfers to the clearing agency to be final when effected. The exact nature of any rules and procedures a clearing agency would likely establish to support this requirement is likely to vary between clearing agencies. However, there are estimates of the burden imposed by similar policies and procedures requirements in Regulation NMS and in proposed requirements for security-based swap data repositories.[209] While the requirements underlying those estimates are not identical to this requirement for clearing agencies, the Commission preliminarily believes that for PRA purposes there is similarity in the burden to create policies and procedures.

Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and in the proposed requirements for security-based swap data repositories, the Commission preliminarily estimates that proposed Rule 17Ad-22(d)(5) would impose a one-time burden on each respondent clearing agency of 210 hours, corresponding to an aggregate one-time burden on all respondent clearing agencies of 3,570 hours.[210] The Commission solicits comment regarding the accuracy of this estimate.

Clearing agencies would be required to administer their settlement arrangements required by proposed Rule 17Ad-22(d)(5) on an ongoing basis. The Commission expects that the exact burden of administering the procedures for monitoring settlement arrangements would vary depending on how frequently each clearing agency may need to update its procedures. Based on the analogous policies and procedures requirements and the corresponding burden estimates in

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209 See supra note 157.

210 This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) + (Senior Business Analyst at 23 hours)) = 210 hours x 17 respondent clearing agencies = 3,570 hours. See supra note 195.

Regulation NMS and for security-based swap data repositories, the Commission estimates that the ongoing requirements of this rule would impose an aggregate annual burden of 60 hours on each respondent clearing agency, corresponding to an aggregate annual burden for all respondent clearing agencies of 1,020 hours.[211] The Commission solicits comment regarding the accuracy of this estimate.

o. Cost-Effectiveness

Proposed Rule 17Ad-22(d)(6) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to be cost effective in meeting the requirements of participants while maintaining safe and secure operations. The exact nature of any rules and procedures a clearing agency would likely establish to support this requirement is likely to vary between clearing agencies. However, there are estimates of the burden imposed by similar policies and procedures requirements in Regulation NMS and in proposed requirements for security-based swap data repositories.[212] While the requirements underlying those estimates are not identical to this requirement for clearing agencies, the Commission preliminarily believes that for PRA purposes there is similarity in the burden to create policies and procedures.

Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and in the proposed requirements for security-based swap data repositories, the Commission preliminarily estimates that proposed Rule 17Ad-22(d)(6) would impose a one-time burden on each respondent clearing agency of 210 hours,

211 This figure was calculated as follows: Compliance Attorney at 60 hours x 17 respondent clearing agencies = 1,020 hours for all respondent clearing agencies. See supra note 196.

212 See supra note 157.

corresponding to an aggregate one-time burden on all respondent clearing agencies of 3,570 hours.[213] The Commission solicits comment regarding the accuracy of this estimate.

Clearing agencies would be required to administer their cost-effectiveness standards required by proposed Rule 17Ad-22(d)(6) on an ongoing basis. The Commission expects that the exact burden of administering the procedures for monitoring cost-effectiveness standards would vary depending on how frequently each clearing agency may need to update its procedures. Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and for security-based swap data repositories, the Commission estimates that the ongoing requirements of this rule would impose an aggregate annual burden of 60 hours on each respondent clearing agency, corresponding to an aggregate annual burden for all respondent clearing agencies of 1,020 hours.[214] The Commission solicits comment regarding the accuracy of this estimate.

p. Links

Proposed Rule 17Ad-22(d)(7) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to evaluate the potential sources of risks that can arise when the clearing agency establishes links either cross-border or domestically to clear trades and ensure that the risks are managed prudently on an ongoing basis. The exact nature of any rules and procedures a clearing agency would likely establish to support this requirement is likely to vary between clearing agencies. However, there are estimates of the burden imposed by similar policies and procedures requirements in

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213 This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) + (Senior Business Analyst at 23 hours)) = 210 hours x 17 respondent clearing agencies = 3,570 hours. See supra note 195.

214 This figure was calculated as follows: Compliance Attorney at 60 hours x 17 respondent clearing agencies = 1,020 hours for all respondent clearing agencies. See supra note 196.

Regulation NMS and in proposed requirements for security-based swap data repositories.[215] While the requirements underlying those estimates are not identical to this requirement for clearing agencies, the Commission preliminarily believes that for PRA purposes there is similarity in the burden to create policies and procedures.

Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and in the proposed requirements for security-based swap data repositories, the Commission preliminarily estimates that proposed Rule 17Ad-22(d)(7) would impose a one-time burden on each respondent clearing agency of 210 hours, corresponding to an aggregate one-time burden on all respondent clearing agencies of 3,570 hours.[216] The Commission solicits comment regarding the accuracy of this estimate.

Clearing agencies would be required to administer their links arrangements as required by proposed Rule 17Ad-22(d)(7) on an ongoing basis. The Commission expects that the exact burden of administering the procedures for monitoring links arrangements would vary depending on how frequently each clearing agency may need to update its procedures. Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and for security-based swap data repositories, the Commission estimates that the ongoing requirements of this rule would impose an aggregate annual burden of 60 hours on each respondent clearing agency, corresponding to an aggregate annual burden for all respondent

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[215] See supra note 157.

[216] This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) + (Senior Business Analyst at 23 hours)) = 210 hours x 17 respondent clearing agencies = 3,570 hours. See supra note 195.

clearing agencies of 1,020 hours.[217] The Commission solicits comment regarding the accuracy of this estimate.

q. Governance

Proposed Rule 17Ad-22(d)(8) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to have governance arrangements that are clear and transparent to fulfill the public interest requirements in Section 17A of the Act applicable to clearing agencies, to support the objectives of owners and participants, and to promote the effectiveness of the clearing agency's risk management procedures. The exact nature of any rules and procedures a clearing agency would likely establish to support this requirement is likely to vary between clearing agencies. However, there are estimates of the burden imposed by similar policies and procedures requirements in Regulation NMS and in proposed requirements for security-based swap data repositories.[218] While the requirements underlying those estimates are not identical to this requirement for clearing agencies, the Commission preliminarily believes that for PRA purposes there is similarity in the burden to create policies and procedures.

Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and in the proposed requirements for security-based swap data repositories, the Commission preliminarily estimates that proposed Rule 17Ad-22(d)(8) would impose a one-time burden on each respondent clearing agency of 210 hours,

217 This figure was calculated as follows: Compliance Attorney at 60 hours x 17 respondent clearing agencies = 1,020 hours for all respondent clearing agencies. See supra note 196.

218 See supra note 157.

corresponding to an aggregate one-time burden on all respondent clearing agencies of 3,570 hours.[219] The Commission solicits comment regarding the accuracy of this estimate.

Clearing agencies would be required to administer their governance arrangements as required by proposed Rule 17Ad-22(d)(8) on an ongoing basis. The Commission expects that the exact burden of administering the procedures for monitoring governance arrangements would vary depending on how frequently each clearing agency may need to update its procedures. Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and for security-based swap data repositories, the Commission estimates that the ongoing requirements of this rule would impose an aggregate annual burden of 60 hours on each respondent clearing agency, corresponding to an aggregate annual burden for all respondent clearing agencies of 1,020 hours.[220] The Commission solicits comment regarding the accuracy of this estimate.

Based on information from respondents that are already subject to a similar requirement in the CDS Clearing Exemption Orders to make publicly available certain pricing and valuation information with respect to security-based swaps,[221] the Commission estimates that the one-time burden for a clearing agency to provide transparency about its governance arrangements to fulfill the public interest requirements in Section 17A of the Exchange Act would involve slight adjustments to data systems that would already be in place as part of the clearing agency's operations. Therefore, the Commission does not anticipate that new hardware, such as additional

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219 This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) + (Senior Business Analyst at 23 hours)) = 210 hours x 17 respondent clearing agencies = 3,570 hours. See supra note 195.

220 This figure was calculated as follows: Compliance Attorney at 60 hours x 17 respondent clearing agencies = 1,020 hours for all respondent clearing agencies. See supra note 196.

221 See infra notes 251 –254 and accompanying text.

computer equipment, would be required. Instead, the Commission broadly estimates that for a clearing agency to adjust its systems to meet the requirements of proposed Rule 17Ad-22(d)(8) would impose a one-time burden of 100 hours on each respondent clearing agency, corresponding to an aggregate one-time burden imposed on all respondent clearing agencies of 1,700 hours.[222] The Commission solicits comment regarding the accuracy of this estimate.

r. Information on Services

Proposed Rule 17Ad-22(d)(9) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide market participants with sufficient information for them to identify and evaluate the risks and costs associated with using their services. The exact nature of any rules and procedures a clearing agency would likely establish to support this requirement is likely to vary between clearing agencies. However, there are estimates of the burden imposed by similar policies and procedures requirements in Regulation NMS and in proposed requirements for security-based swap data repositories.[223] While the requirements underlying those estimates are not identical to this requirement for clearing agencies, the Commission preliminarily believes that for PRA purposes there is similarity in the burden to create policies and procedures.

Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and in the proposed requirements for security-based swap data repositories, the Commission preliminarily estimates that proposed Rule 17Ad-22(d)(9) would impose a one-time burden on each respondent clearing agency of 210 hours,

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222 This figure was calculated as follows: ((Chief Compliance Officer at 40 hours) + (Computer Operations Department Manager at 40 hours) + (Senior Programmer at 20 hours)) x 17 respondent clearing agencies = 1,700 hours. See infra note 253 and accompanying text.

223 See supra note 157.

corresponding to an aggregate one-time burden on all respondent clearing agencies of 3,570 hours.[224] The Commission solicits comment regarding the accuracy of this estimate.

Respondent clearing agencies would also have an ongoing responsibility to make this information available. Also based on informal comments from respondents already subject to a similar requirement in the CDS Clearing Exemption Orders to make certain pricing and valuation information with respect to security-based swaps publicly available, the Commission preliminarily believes that the ongoing burden would be limited and would likely involve maintenance and troubleshooting of computer systems used to facilitate dissemination of information responsive to Rule 17Ad-22(d)(9). Therefore, the Commission preliminarily estimates this would impose an annual aggregate burden of 60 hours for each respondent clearing agency, which corresponds to an ongoing aggregate annual burden of 1,020 hours for all respondent clearing agencies.[225] The Commission solicits comment regarding the accuracy of this estimate.

Based on information from respondents that are already subject to a similar requirement in the CDS Clearing Exemption Orders to make publicly available certain pricing and valuation information with respect to security-based swaps,[226] the Commission estimates that the one-time burden to provide market participants with sufficient information for them to identify and evaluate accurately the risks and costs associated with using a clearing agency's services would

224 This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) + (Senior Business Analyst at 23 hours)) = 210 hours x 17 respondent clearing agencies = 3,570 hours. See supra note 195.

225 This figure was calculated as follows: Computer Operations Department Manager at 60 hours annually x 17 respondent clearing agencies = 1,020 hours for all respondent clearing agencies. See supra note 196.

226 See infra notes 251 –254 and accompanying text.

involve slight adjustments to data systems that would already be in place as part of the clearing agency's operations under Exchange Act Section 17A. Therefore, the Commission does not anticipate that new hardware, such as additional computer equipment, would be required. Instead, the Commission broadly estimates that for a clearing agency to adjust its systems to meet the requirements of proposed Rule 17Ad-22(d)(9) would impose a one-time burden of 100 hours on each respondent clearing agency, corresponding to an aggregate one-time burden imposed on all respondent clearing agencies of 1,700 hours.[227] The Commission solicits comment regarding the accuracy of this estimate.

s. Immobilization and Dematerialization of Stock Certificates

Proposed Rule 17Ad-22(d)(10) would require clearing agencies that provide central securities depository services to establish, implement, maintain and enforce written policies and procedures reasonably designed to immobilize or dematerialize securities certificates and transfer them by book entry to the greatest extent possible. The exact nature of any rules and procedures a clearing agency would likely establish to support this requirement is likely to vary between clearing agencies. However, there are estimates of the burden imposed by similar policies and procedures requirements in Regulation NMS and in proposed requirements for security-based swap data repositories.[228] While the requirements underlying those estimates are not identical to this requirement for clearing agencies, the Commission preliminarily believes that for PRA purposes there is similarity in the burden to create policies and procedures.

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227 This figure was calculated as follows: ((Chief Compliance Officer at 40 hours) + (Computer Operations Department Manager at 40 hours) + (Senior Programmer at 20 hours)) x 17 respondent clearing agencies = 1,700 hours. See infra note 253 and accompanying text.

228 See supra note 157.

Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and in the proposed requirements for security-based swap data repositories, the Commission preliminarily estimates that proposed Rule 17Ad-22(d)(10) would impose a one-time burden on each respondent clearing agency of 210 hours, corresponding to an aggregate one-time burden on all respondent clearing agencies of 3,570 hours.[229] The Commission solicits comment regarding the accuracy of this estimate.

Clearing agencies that provide central securities depository services would be required to administer their standards for immobilizing or dematerializing securities certificates as required by proposed Rule 17Ad-22(d)(10) on an ongoing basis. The Commission expects that the exact burden of administering the procedures for immobilizing and dematerializing securities certificates would vary depending on how frequently each clearing agency may need to update its procedures. Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and for security-based swap data repositories, the Commission estimates that the ongoing requirements of this rule would impose an aggregate annual burden of 60 hours on each respondent clearing agency, corresponding to an aggregate annual burden for all respondent clearing agencies of 1020 hours.[230] The Commission solicits comment regarding the accuracy of this estimate.

t. Default Procedures

Proposed Rule 17Ad-22(d)(11) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to make key aspects of

229 This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) + (Senior Business Analyst at 23 hours)) = 210 hours x 17 respondent clearing agencies = 3,570 hours. See supra note 195.

230 This figure was calculated as follows: Compliance Attorney at 60 hours x 17 respondent clearing agency = 1020 hours for all respondent clearing agencies. See supra note 196.

the clearing agency's default procedures publicly available and to establish default procedures that ensure that the clearing agency can take timely action to contain losses and liquidity pressures and to continue meeting its obligations in the event of a participant default. The exact nature of the procedures a clearing agency would establish is likely to vary between clearing agencies. However, there are estimates of the burden imposed by similar policies and procedures requirements in Regulation NMS and in proposed requirements for security-based swap data repositories.[231] While the requirements underlying those estimates are not identical to this requirement for clearing agencies, the Commission preliminarily believes that for PRA purposes there is similarity in the burden to create policies and procedures.

Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and in the proposed requirements for security-based swap data repositories, the Commission preliminarily estimates that proposed Rule 17Ad-22(d)(11) would impose a one-time burden on each respondent clearing agency of 210 hours, corresponding to an aggregate one-time burden on all respondent clearing agencies of 3,570 hours.[232]

Clearing agencies would be required to administer their default standards required by proposed Rule 17Ad-22(d)(11) on an ongoing basis. The Commission expects that the exact burden of administering the procedures for monitoring default standards would vary depending on how frequently each clearing agency may need to update its procedures. Based on the analogous policies and procedures requirements and the corresponding burden estimates in

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231 See supra note 157.

232 This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) + (Senior Business Analyst at 23 hours)) = 210 hours x 17 respondent clearing agencies = 3,570 hours. See supra note 195.

Regulation NMS and for security-based swap data repositories, the Commission estimates that the ongoing requirements of this rule would impose an aggregate annual burden of 60 hours on each respondent clearing agency, corresponding to an aggregate annual burden for all respondent clearing agencies of 1,020 hours.[233] The Commission solicits comment regarding the accuracy of this estimate.

Based on information from respondents that are already subject to a similar requirement in the CDS Clearing Exemption Orders to make publicly available certain pricing and valuation information with respect to security-based swaps,[234] the Commission estimates that the one-time burden for a clearing agency to make key aspects of its default procedures publicly available would involve slight adjustments to data systems that would already be in place as part of the clearing agency's operations under Section 17A of the Exchange Act. Therefore, the Commission does not anticipate that new hardware, such as additional computer equipment, would be required. Instead, the Commission broadly estimates that for a clearing agency to adjust its systems to meet the requirements of proposed Rule 17Ad-22(d)(11) would impose a one-time burden of 100 hours on each respondent clearing agency, corresponding to an aggregate one-time burden imposed on all respondent clearing agencies of 1,700 hours.[235] The Commission solicits comment regarding the accuracy of this estimate.

u. Timing of Settlement Finality

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233 This figure was calculated as follows: Compliance Attorney at 60 hours x 17 respondent clearing agencies = 1,020 hours. See supra note 196.

234 See infra notes 251 –254 and accompanying text.

235 This figure was calculated as follows: ((Chief Compliance Officer at 40 hours) + (Computer Operations Department Manager at 40 hours) + (Senior Programmer at 20 hours)) x 17 respondent clearing agencies = 1,700 hours. See infra note 253 and accompanying text.

Proposed Rule 17Ad-22(d)(12) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to ensure that final settlement occurs no later than the end of the settlement day and require that intraday or real-time finality be provided where necessary to reduce risks. The exact nature of the procedures a clearing agency would establish is likely to vary between clearing agencies. However, there are estimates of the burden imposed by similar policies and procedures requirements in Regulation NMS and in proposed requirements for security-based swap data repositories. While the requirements underlying those estimates are not identical to this requirement for clearing agencies, the Commission preliminarily believes that for PRA purposes there is similarity in the burden to create policies and procedures.

Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and in the proposed requirements for security-based swap data repositories, the Commission preliminarily estimates that proposed Rule 17Ad-22(d)(12) would impose a one-time burden on each respondent clearing agency of 210 hours, corresponding to an aggregate one-time burden on all respondent clearing agencies of 3,570 hours.[236]

Clearing agencies would be required to administer their settlement finality standards required by proposed Rule 17Ad-22(d)(12) on an ongoing basis. The Commission expects that the exact burden of administering the procedures for ensuring the timing of settlement finality would vary depending on how frequently each clearing agency may need to update its

236 This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) + (Senior Business Analyst at 23 hours)) = 210 hours x 17 respondent clearing agencies = 3,570 hours. See supra note 195.

procedures. Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and for security-based swap data repositories, the Commission estimates that the ongoing requirements of this rule would impose an aggregate annual burden of 60 hours on each respondent clearing agency, corresponding to an aggregate annual burden for all respondent clearing agencies of 1,020 hours.[237] The Commission solicits comment regarding the accuracy of this estimate.

v. Delivery Versus Payment

Proposed Rule 17Ad-22(d)(13) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to eliminate principal risk by linking securities transfers to funds transfers in a way that achieves delivery versus payment. The exact nature of the procedures a clearing agency would establish is likely to vary between clearing agencies. However, there are estimates of the burden imposed by similar policies and procedures requirements in Regulation NMS and in proposed requirements for security-based swap data repositories.[238] While the requirements underlying those estimates are not identical to this requirement for clearing agencies, the Commission preliminarily believes that for PRA purposes there is similarity in the burden to create policies and procedures.

Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and in the proposed requirements for security-based swap data repositories, the Commission preliminarily estimates that proposed Rule 17Ad-22(d)(13) would impose a one-time burden on each respondent clearing agency of 210 hours,

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237 This figure was calculated as follows: Compliance Attorney at 60 hours x 17 respondent clearing agencies = 1,020 hours. See supra note 196.

238 See supra note 157.

corresponding to an aggregate one-time burden on all respondent clearing agencies of 3,570 hours.[239]

Clearing agencies would be required to administer their delivery versus payment standards required by proposed Rule 17Ad-22(d)(13) on an ongoing basis. The Commission expects that the exact burden of administering the procedures for delivery versus payment would vary depending on how frequently each clearing agency may need to update its procedures. Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and for security-based swap data repositories, the Commission estimates that the ongoing requirements of this rule would impose an aggregate annual burden of 60 hours on each respondent clearing agency, corresponding to an aggregate annual burden for all respondent clearing agencies of 1,020 hours.[240] The Commission solicits comment regarding the accuracy of this estimate.

w. Risk Controls to Address Participants' Failure to Settle

Proposed Rule 17Ad-22(d)(14) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to institute risk controls, including collateral requirements and limits to cover the clearing agency's credit exposure to each participant exposure fully, and that ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle when the clearing agency provides central securities depository services and extends intraday credit to participants. The

239 This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) + (Senior Business Analyst at 23 hours)) = 210 hours x 17 respondent clearing agencies = 3,570 hours. See supra note 195.

240 This figure was calculated as follows: Compliance Attorney at 60 hours x 17 respondent clearing agencies = 1,020 hours. See supra note 196.

exact nature of any rules and procedures a clearing agency would likely establish to support this requirement is likely to vary between clearing agencies. However, there are estimates of the burden imposed by similar policies and procedures requirements in Regulation NMS and in proposed requirements for security-based swap data repositories.[241] While the requirements underlying those estimates are not identical to this requirement for clearing agencies, the Commission preliminarily believes that for PRA purposes there is similarity in the burden to create policies and procedures.

Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and in the proposed requirements for security-based swap data repositories, the Commission preliminarily estimates that proposed Rule 17Ad-22(d)(14) would impose a one-time burden on each respondent clearing agency of 210 hours, corresponding to an aggregate one-time burden on all respondent clearing agencies of 3,570 hours.[242] The Commission solicits comment regarding the accuracy of this estimate.

Clearing agencies that provide central securities depository services would be required to administer their risk control standards required by proposed Rule 17Ad-22(d)(14) on an ongoing basis. The Commission expects that the exact burden of administering the procedures for risk controls, including collateral requirements and limits to cover the clearing agency's credit exposure to each participant exposure fully and that ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle would vary depending on how frequently each clearing agency may need to update its procedures. Based on the analogous

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241 See supra note 157.

242 This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) + (Senior Business Analyst at 23 hours)) = 210 hours x 17 respondent clearing agencies = 3,570 hours. See supra note 195.

policies and procedures requirements and the corresponding burden estimates in Regulation NMS and for security-based swap data repositories, the Commission estimates that the ongoing requirements of this rule would impose an aggregate annual burden of 60 hours on each respondent clearing agency, corresponding to an aggregate annual burden for all respondent clearing agencies of 1,020 hours.[243] The Commission solicits comment regarding the accuracy of this estimate.

x. Identification and Management of Physical Delivery Risks

Proposed Rule 17Ad-22(d)(15) would require a clearing agency to state to its participants the clearing agency's obligations with respect to physical deliveries and to identify and manage the risks that arise in connection with these obligations. The exact form in which a clearing agency would state to its participants the clearing agency's obligations with respect to physical deliveries and to identify and manage the risks in connection with those obligations is likely to vary between clearing agencies. However, there are estimates of the burden imposed by similar policies and procedures requirements in Regulation NMS and in proposed requirements for security-based swap data repositories.[244] While the requirements underlying those estimates are not identical to this requirement for clearing agencies, the Commission preliminarily believes that for PRA purposes there is similarity in the burden to create policies and procedures.

Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and in the proposed requirements for security-based swap data repositories, the Commission preliminarily estimates that proposed Rule 17Ad-22(d)(15) would impose a one-time burden on each respondent clearing agency of 210 hours,

243 This figure was calculated as follows: Compliance Attorney at 60 hours x 17 respondent clearing agencies = 1,020 hours for all respondent clearing agencies. See supra note 196.

244 See supra note 157

corresponding to an aggregate one-time burden on all respondent clearing agencies of 3,570 hours.[245] The Commission solicits comment regarding the accuracy of this estimate.

Clearing agencies would be required to administer their physical delivery standards required by proposed Rule 17Ad-22(d)(15) on an ongoing basis. The Commission expects that the exact burden of administering the procedures for monitoring physical delivery standards would vary depending on how frequently each clearing agency may need to update its procedures. Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and for security-based swap data repositories, the Commission estimates that the ongoing requirements of this rule would impose an aggregate annual burden of 60 hours on each respondent clearing agency, corresponding to an aggregate annual burden for all respondent clearing agencies of 1,020 hours.[246] The Commission solicits comment regarding the accuracy of this estimate.

Based on information from respondents that are already subject to a similar requirement in the CDS Clearing Exemption Orders to make publicly available certain pricing and valuation information with respect to security-based swaps,[247] the Commission estimates that the one-time burden for a clearing agency to state to its participants its obligations with respect to physical deliveries would involve slight adjustments to data systems that would already be in place as part of the clearing agency's operations under Section 17A of the Exchange Act. Therefore, the Commission does not anticipate that new hardware, such as additional computer equipment,

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245 This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) + (Senior Business Analyst at 23 hours)) = 210 hours x 17 respondent clearing agencies = 3,570 hours. See supra note 195.

246 This figure was calculated as follows: Compliance Attorney at 60 hours x 17 respondent clearing agencies = 1,020 hours. See supra note 196.

247 See infra notes 251 –254 and accompanying text.

would be required. Instead, the Commission broadly estimates that for a clearing agency to adjust its systems to meet the requirements of proposed Rule 17Ad-22(d)(15) would impose a one-time burden of 100 hours on each respondent clearing agency, corresponding to an aggregate one-time burden imposed on all respondent clearing agencies of 1,700 hours.[248] The Commission solicits comment regarding the accuracy of this estimate.

Total Burden

The Commission preliminarily believes that for all respondent clearing agencies the aggregate paperwork burdens contained in proposed Rules 17Ad-22(d)(1), (2), (3), (4), (5), (6), (7), (8), (9), (10), (11), (12), (13), (14), (15), (b)(1), (2), (3), (4), (5), (6), (7), (c)(1) and (2) would impose a one-time burden of 83,343 hours[249] and an ongoing annual burden of 39,658 hours.[250] The Commission solicits comment regarding the accuracy of this estimate.

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248 This figure was calculated as follows: ((Chief Compliance Officer at 40 hours) + (Computer Operations Department Manager at 40 hours) + (Senior Programmer at 20 hours)) x 17 respondent clearing agencies = 1,700 hours. See infra note 253 and accompanying text.

249 This figure combines the one-time burdens for proposed Rules 17Ad-22(d)(1), (2), (3), (4), (5), (6), (7), (8), (9), (10), (11), (12), (13), (14), (15), (b)(1), (2), (3), (4), (5), (6), (7), (c)(1) and (2) and was calculated as follows: (((3,570 hours x 16 standards pursuant to proposed Rules 17Ad-22(d)(1), (2), (3), (4), (5), (6), (7), (8), (9), (10), (11), (12), (13), (14), (15) and (d)(2) = 57,123 hours) + (1,890 hours x 8 standards pursuant to proposed Rules 17Ad-22(b)(1), (2), (3), (4), (5), (6), (7) and (d)(1) = 15,120 hours) + (1,700 hours x 6 systems adjustments pursuant to Rules 17Ad-22(d)(2), (8), (9), (11), (15), (d)(2) = 10,200 hours) + (900 hours x 1 systems adjustment pursuant to Rule 17Ad-22(c)(1)) = 83,343 hours.

250 This figure combines the annual burdens for proposed Rules 17Ad-22(d)(1), (2), (3), (4), (5), (6), (7), (8), (9), (10), (11), (12), (13), (14), (15),(b)(1), (2), (3), (4), (5), (6), (7), (c)(1) and (2) and was calculated as follows: ((1,020 hours x 16 standards to be administered pursuant to Rules 17Ad-22(d)(1), (2), (3), (4), (5), (6), (7), (8), (9),(10), (11), (12), (13), (14), (15) and (d)(2) = 16,320 hours) + (540 hours x 8 standards to be administered pursuant to proposed Rules 17Ad-22(b)(1), (2), (3), (4), (5), (6), (7) and (d)(1) = 4,320 hours) + (1,020 hours x 2 ongoing efforts to maintain and troubleshoot computer systems used to facilitate dissemination of information responsive to Rules 17Ad-22(d)(2) and (9) = 2,040 hours) + (6,480 hours to prepare the annual model validation required pursuant to Rule 17Ad-22(b)(4)) + (1,890 hours to prepare revised

2. Dissemination of Pricing and Valuation Information by Security-Based Swap Clearing Agencies that Perform Central Counterparty Services

The requirement for dissemination of pricing and valuation information in proposed Rule 17Aj-1 would effectively require each of the entities authorized to provide CCP services for security-based swaps pursuant to the CDS Clearing Exemption Orders[251] to continue the information dissemination practices they already perform. These entities generate end of day settlement prices and other model prices for security-based swaps, which can be used to establish margin requirements for participant positions and could provide prices in the event of a default scenario. As outlined above, the Commission estimates a total of six respondents would be subject to this requirement.[252]

Based on information from respondents that are already subject to a similar requirement in the CDS Clearing Exemption Orders to disseminate pricing and valuation information, the Commission preliminarily believes that the requirements of proposed Rule 17Aj-1 would impose one-time and ongoing burdens on respondent clearing agencies. For instance, compliance professionals may need to work with information technology and operations professionals to accurately memorialize in writing the specific policy and procedure requirements regarding the dissemination of pricing and valuation information. Information technology personnel may be

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policies and procedures providing for a higher net capital requirement pursuant to Rule 17Ad-22(b)(7) + (108 hours to generate the financial information required pursuant to Rule 17Ad-22(c)(1)) + (8,500 hours to coordinate the posting of financial information to the clearing agency's website as required pursuant to Rule 17Ad-22(c)(2)) = 39, 658 hours.

251 See supra note 6.

252 See supra notes 139 – 140 and accompanying text. The Commission notes that clearing agencies operating under the existing CDS Clearing Exemption Orders may not need to make additional changes to meet the requirements of the proposed rule because they are already subject to similar conditions as part of the orders. However, for purposes of this PRA analysis the Commission assumes that these would be new requirements.

relied on to develop or modify computer programs that facilitate the requirements of the policies and procedures.

The Commission estimates that the one-time burden for a security-based swap clearing agency to comply with the requirements of proposed Rule 17Aj-1 would involve slight adjustments to data systems that would already be in place as part of the operation of the respondent as a registered clearing agency that provides CCP services for security-based swaps. Therefore, the Commission does not anticipate that new hardware, such as additional computer equipment, would be required. Instead, the Commission broadly estimates that for a clearing agency to adjust its systems to meet the requirements of proposed Rule 17Aj-1 would impose a one-time burden of 100 hours on each respondent clearing agency, corresponding to an aggregate one-time burden imposed on all respondent clearing agencies of 600 hours.[253] The Commission solicits comment regarding the accuracy of this estimate.

Respondent clearing agencies would also have an ongoing responsibility to make their relevant pricing and valuation information available. Based on informal comments from respondents that are already subject to a similar requirement in the CDS Clearing Exemption Orders, the Commission preliminarily believes that the ongoing burden would be limited and would likely involve maintenance and troubleshooting of computer systems used to facilitate dissemination of covered pricing and valuation information. Therefore, the Commission preliminarily estimates this would impose an annual aggregate burden of 60 hours for each respondent clearing agency, which corresponds to an ongoing aggregate annual burden of 360

253 This figure was calculated as follows: ((Chief Compliance Officer at 40 hours) + (Computer Operations Department Manager at 40 hours) + (Senior Programmer at 20 hours)) = 100 hours x 6 respondent clearing agencies = 600 hours.

hours for all respondent clearing agencies.[254] The Commission solicits comment regarding the accuracy of this estimate.

3. Clearing Agency Policies and Procedures to Protect the Confidentiality of Trading Information of Clearing Agency Participants

Proposed Rule 17Ad-23 would require each clearing agency to establish, maintain and enforce written policies and procedures designed to protect the confidentiality of clearing members' trading information. As outlined above, the Commission estimates a total of 17 respondents to this requirement.[255]

Based on the staff's conversations with respondents that are already subject to a similar policies and procedures requirement as part of the CDS Clearing Exemption Orders, the Commission preliminarily believes that establishing, maintaining and enforcing written policies and procedures to protect confidential information of clearing members would require collaboration and coordination across business units within the clearing agency. For instance, legal or compliance professionals may need to work with information technology and operations professionals to accurately memorialize in writing the specific policy and procedure requirements that the clearing agency decides to establish. Information technology personnel may be heavily relied on to develop or modify computer programs that facilitate the requirements of the policies and procedures. Developing business practices that are synchronized with the policies and procedures may also entail coordination with the clearing agency's human resources or risk management personnel to ensure effective adoption of any

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254 This figure was calculated as follows: Computer Operations Department Manager at 60 hours annually x 6 respondent clearing agencies = 360 hours.

255 <u>See</u> <u>supra</u> notes 141 – 144 and accompanying text.

employee training created to inform employees about trading restrictions or other areas of the policies and procedures that impact them.

The exact nature of the written policies and procedures a clearing agency would establish is likely to vary. However, based on preliminary information from respondents that are affected by similar requirements under the CDS Clearing Exemption Orders and also based on the Commission's experience in administering those orders, the Commission preliminarily believes that the proposed rule would impose a one-time burden on each respondent clearing agency of 610 hours, corresponding to an aggregate one-time burden on all respondent clearing agencies of 10,370 hours.[256] The Commission solicits comment regarding the accuracy of this estimate.

Also based on information from respondents that have been subject to the CDS Clearing Exemption Orders, the Commission preliminarily believes that a clearing agency would likely purchase computer software from a third party vendor that the clearing agency would then use to implement the aspects of its policies and procedures designed to restrict, as appropriate, the trading of clearing agency employees for their own account and to prevent misuse and misappropriation of participant information protected by the rule. The cost of such computer software is likely to vary according to the specific policies and procedures of the clearing agency (i.e., based on the number of licenses it may need to cover its employees, the types of services it needs the software to provide, etc.). However the Commission preliminarily estimates that the rule would impose a one-time cost of approximately $10,000 dollars on each clearing agency,

256 This figure was calculated as follows: ((Chief Compliance Officer at 210 hours) + (Computer Operations Department Manager at 180 hours) + (Senior Programmer at 180 hours) + (Senior Risk Management Specialist at 40 hours)) = 610 hours x 17 respondent clearing agencies = 10,370 hours.

corresponding to an aggregate one time burden on all clearing agencies of \$170,000.[257] The Commission solicits comment regarding the accuracy of this estimate.

The Commission also preliminarily understands from respondents subject to the similar requirement in the CDS Clearing Exemption Orders that monitoring and enforcing the written policies and procedures required by proposed Rule 17Ad-23 would likely require resource commitments from many of the same business units needed to develop such policies and procedures. For instance, as part of the effort to restrict, as appropriate, trading by clearing agency employees for their own accounts and to prevent misuse and misappropriation of information protected by the rule, the Commission preliminarily believes a clearing agency would need to devote fifty percent of the work hours of a full-time, compliance attorney. The Commission preliminarily expects this resource commitment may, among other things, take the form of obtaining and reviewing brokerage statements of clearing agency employees and reviewing their e-mails. Time for employee training related to the requirements of the policies and procedures, troubleshooting any computer systems designed to protect information in connection with the policies and procedures, and amendments to the policies and procedures are also factors that may contribute to the ongoing burden on clearing agencies. Accordingly, the Commission preliminarily estimates the rule would impose an annual aggregate burden on each respondent of 1,128 hours, corresponding to an aggregate annual burden on all clearing agencies of 19,176 hours.[258] The Commission solicits comment regarding the accuracy of this estimate.

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257 This figure was calculated as follows: \$10,000 dollars in software costs per respondent clearing agency x 17 respondent clearing agencies = \$170,000.

258 This figure was calculated as follows ((Compliance Attorney at 4 hours per business day x 260 business days per year) = 1040 hours per year + (Computer Operations Department Manager at 40 hours per year) + (Senior Programmer at 40 hours per year) + (Senior Risk Management Specialist at 8 hours per year)) = 1,128 hours per year x 17 respondent clearing agencies = 19,176 hours per year.

4. Clearing Agency Procedures to Identify and Address Conflicts of Interest

Proposed Rule 17Ad-25 would require each clearing agency to establish, implement, maintain and enforce written policies and procedures that are reasonably designed to identify and address existing or potential conflicts of interest and minimize conflicts of interest in the decision-making process of the clearing agency. As outlined above, the Commission estimates a total of 17 respondents to this requirement.[259]

The exact nature of the policies and procedures a clearing agency would establish is likely to vary between clearing agencies. For instance, legal or compliance professionals may need to work to accurately memorialize in writing the specific policy and procedure requirements regarding conflicts of interest. Information technology personnel may be relied on to develop, modify or implement computer programs that facilitate the requirements of the policies and procedures.

There are estimates of the burden imposed by similar policies and procedures requirements in Regulation NMS and in proposed requirements for security-based swap data repositories.[260] While the requirements underlying those estimates are not identical to this requirement for clearing agencies, the Commission preliminarily believes that for PRA purposes there is similarity in the burden to create policies and procedures.

Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and in the proposed requirements for security-based swap data repositories, the Commission preliminarily estimates that proposed Rule 17Ad-25 would impose a one-time burden on each respondent clearing agency of 420 hours, corresponding to an

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259 See supra notes 145 – 148 and accompanying text.

260 See supra note 157.

aggregate one-time burden on all respondent clearing agencies of 7,140 hours.[261] Also based on the estimates in Regulation NMS and for security-based swap data repositories, the Commission estimates that a burden of $40,000 in initial outside legal costs would be incurred per respondent clearing agency for an aggregate outside cost burden of $680,000 for all clearing agencies.[262] The Commission solicits comment regarding the accuracy of these estimates.

For a clearing agency to monitor, enforce, and potentially adjust its policies and procedures in connection with proposed Rule 17Ad-25, the Commission preliminarily believes these activities would impose an ongoing aggregate annual burden on each respondent clearing agency of 120 hours, corresponding to an aggregate annual ongoing burden for all respondents of 2,040 hours.[263] The Commission solicits comment regarding the accuracy of these estimates.

5. Standards for Board or Board Committee Directors

Proposed Rule 17Ad-26 outlines the proposed governance standards that clearing agencies would be required to establish for board or board committee directors. As outlined above, the Commission estimates a total of 17 respondents to this requirement.[264]

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261 This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) + (Senior Business Analyst at 23 hours)) = 210 hours to create one policy and procedure x 2 policies and procedures x 17 respondent clearing agencies = 7,140 hours. See supra note 195.

262 This estimated $680,000 figure has been calculated as follows: $400 per hour cost for outside legal services x 50 hours x 2 policies and procedures x 17 clearing agencies. This is the same estimate used by the Commission for these services in the proposed consolidated audit trail rule. See Exchange Act Release No. 62174 (May 26, 2010), 75 FR 32556 (June 8, 2010).

263 This figure was calculated as follows: Compliance Attorney at 60 hours x 17 respondent clearing agencies = 1,020 hours to administer one policy and procedure x 2 policies and procedures = 2,040 hours. See supra note 196.

264 See supra notes 149 – 152 and accompanying text.

The exact nature of the policies and procedures a clearing agency would establish is likely to vary between clearing agencies. For instance, legal or compliance professionals may need to work with a law firm to accurately memorialize in writing the specific policy and procedure requirements regarding the selection of directors. However, as noted above in the discussion of the burdens associated with proposed Rule 17Ad-25, there are estimates of similar burdens imposed by policies and procedures requirements in Regulation NMS and in the proposed requirements for security-based swap data repositories.[265] While the requirements underlying those estimates are not identical to this requirement for clearing agencies, the Commission preliminarily believes that there is sufficient similarity between them for PRA purposes that the burden would be roughly equivalent.

Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and in the proposed requirements for security-based swap data repositories, the Commission preliminarily believes that this rule would impose an aggregate one-time burden on each respondent clearing agency of 210 hours to create the minimum standards required by the rule, corresponding to a one-time aggregate burden for all clearing agencies of 3,570 hours.[266] The Commission solicits comment regarding the accuracy of this estimate.

The Commission also estimates, based on similar requirements and the corresponding burdens in Regulation NMS and for security-based swap data repositories that a total burden of $20,000 in outside legal costs would be incurred by each respondent clearing agency,

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265 See supra note 157.

266 This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) + (Senior Business Analyst at 23 hours)) = 210 hours x 17 respondent clearing agencies = 3,570 hours. See supra note 195.

corresponding to an aggregate cost burden of $340,000 for all respondent clearing agencies.[267] The Commission solicits comment regarding the accuracy of this information.

Clearing agencies would be required to administer their governance standards required by proposed Rule 17Ad-26 on an ongoing basis. The Commission expects that the exact burden of administering the governance standards would vary depending on factors that include, but are not limited to, how frequently a clearing agency elects new board members and how many board and board committee members are involved with the governance of each clearing agency. These factors would influence the time spent evaluating potential new board members as well as the time needed to assess existing board members at least annually for compliance with the standards.

Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS and for security-based swap data repositories, the Commission estimates that the ongoing requirements of this rule would impose an aggregate annual burden of 60 hours on each respondent clearing agency, corresponding to an aggregate annual burden for all respondent clearing agencies of 1,020 hours.[268] The Commission solicits comment regarding the accuracy of this information. The proposed rule also encourages clearing agencies to use a third party to facilitate completion of the board's annual assessment of its members against its governance standards. The Commission estimates that using a third party would impose an average annual burden of 20 hours on each respondent clearing agency,

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267 This estimated figure was calculated as follows: ($400 per hour cost for outside legal services x 50 hours) x 17 respondent clearing agencies = $170,000. See supra note 262.

268 This figure was calculated as follows: Compliance Attorney at 60 hours x 17 respondent clearing agencies = 1,020 hours. See supra note 196.

corresponding to aggregate of 340 hours all clearing agencies.[269] The Commission solicits comment regarding the accuracy of this estimate.

6. Designation of Chief Compliance Officer

Under proposed Rule 3Cj-1(b), a registered clearing agency's CCO would be responsible for, among other matters, (1) establishing policies and procedures for the remediation of non-compliance issues identified by the CCO and (2) establishing and following appropriate procedures for the handling of management response, remediation, retesting and closing of non-compliance issues. As outlined above, the Commission estimates a total of 17 respondents to this requirement.[270]

The exact nature of the policies and procedures a clearing agency would establish is likely to vary between clearing agencies. However, as noted in the discussion of the estimated burdens for proposed Rules 17Ad-25 and 17Ad-26, there are similarly positioned requirements and corresponding burden estimates in Regulation NMS and in the proposed requirements for security-based swap data repositories.[271] The proposed rule requirements that create the estimated PRA burden for the CCO of a security-based swap data repository[272] are highly-similar to the proposed requirements for the CCO of a clearing agency in Rule 3Cj-1(b).[273] This is because both rules are predicated on statutory provisions of the Exchange Act that contain

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269 This figure was calculated as follows: Consultant at 20 hours x 17 respondent clearing agencies = 340 hours.

270 See supra note 153 – 156 and accompanying text.

271 See supra note 157.

272 See Exchange Act Release No. 63347 (November 19, 2010), 75 FR 77306 (December 10, 2010) (proposed Rules 13n-11(c)(6),(7) and 13n-11(d), (h). See generally Pub. L. No. 111-203 § 763(a) (adding Section 3C(n)(6) to the Exchange Act).

273 Compare Pub. L. No. 111-203 § 763(a) adding Section 3C(j) to the Exchange Act concerning requirements for the CCO of a clearing agency with Pub. L. No. 111-203 § 763(a) adding Section 3C(n)(6) concerning requirements for the CCO of an SDR.

statutory requirements that mirror one another to a large degree.[274] Therefore, the Commission preliminarily believes that for PRA purposes the burdens would be roughly equivalent.

Consequently, the Commission preliminarily estimates that the two requirements for the CCO of a clearing agency under proposed Rule 3Cj-1 would require 420 hours to create policies and procedures, corresponding to a total burden of 7,140 hours initially.[275] The Commission also preliminarily estimates 120 hours to administer each policy and procedure per year per respondent, corresponding to 1,200 hours on average annually.[276] The Commission preliminarily believes that this work will be conducted internally and solicits comments regarding the accuracy of this information. The Commission solicits comment regarding the accuracy of these estimates.

Also, based on the similarly positioned burdens in Regulation NMS and in the proposed requirements for the CCO of a security-based swaps data repository, the Commission preliminarily estimates that a total of $40,000 in initial outside legal costs would be incurred by each respondent clearing agency. This corresponds to an aggregate, one-time outside cost

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[274] Compare Pub. L. No. 111-203 § 763(a) adding Section 3C(j) to the Exchange Act concerning requirements for the CCO of a clearing agency with Pub. L. No. 111-203 § 763(a) adding Section 3C(n)(6) concerning requirements for the CCO of an SDR.

[275] This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) + (Senior Business Analyst at 23 hours)) = 210 hours to create one policy and procedure x 2 policies and procedures x 17 respondent clearing agencies = 7,140 hours. See supra note 195.

[276] This figure was calculated as follows: (Compliance Attorney at 60 hours x 17 respondent clearing agencies) = 1,020 hours to administer one policy and procedure x 2 policies and procedures = 2,040 hours. See supra note 196.

burden of $680,000 for all clearing agencies.[277] The Commission solicits comment regarding the accuracy of this estimate.

The CCO would also be required under proposed Rule 3Cj-1(c) to prepare, sign and submit (to the clearing agency's board of directors and audit committee (or equivalent bodies) and to the Commission) an annual compliance report that contains a description of (i) the compliance of the clearing agency with respect to the federal securities laws and the rules and regulations thereunder, and (ii) each policy and procedure of the clearing agency of the compliance officer (including the code of ethics and conflict of interest policies of the registered clearing agency). Based upon the Commission's experience with similar reports, the Commission preliminarily estimates that this would require an average of 54 hours per respondent per year. Thus, the Commission preliminarily estimates an aggregate annual burden of 918 hours on all respondent clearing agencies.[278] Because the report will be submitted by the internal CCO, the Commission preliminarily does not expect any external costs. The Commission solicits comments regarding the accuracy of this estimate.

E. Collection of Information is Mandatory

1. Standards for Clearing Agencies

a. Measurement and Management of Credit Exposures

The collection of information relating to measuring credit exposures to its participants at least once a day and limiting its exposures to potential losses from defaults by its participants in normal market conditions so that the operations of the clearing agency would not be disrupted

277 This figure was calculated as follows: (($400 per hour cost for outside legal services x 50 hours) x (2 policies and procedures)) x 17 clearing agencies = $680,000. See supra note 262.

278 This figure is based on the following: ((Compliance Attorney at 50 hours) + (Senior Systems Analyst at 4 hours)) x 17 clearing agencies = 918 hours.

and non-defaulting participants would not be exposed to losses that they cannot anticipate or control under proposed Rule 17Ad-22(b)(1) would be mandatory for all clearing agencies that provide CCP services.

b. Margin Requirements

The collection of information relating to using margin requirements to limit credit exposures to participants in normal market conditions and using risk-based models and parameters to set margin requirements and review them at least monthly under proposed Rule 17Ad-22(b)(2) would be mandatory for all clearing agencies that provide CCP services.

c. Financial Resources

The collection of information relating to maintaining sufficient financial resources to withstand, at a minimum, a default by the participant to which it has the largest exposure in extreme but plausible market conditions, and if the clearing agency provides CCP services for security-based swaps then a default by the two participants to which it has the largest exposures in extreme but plausible market conditions; provided that if a participant controls another participant or is under common control with another participant, then the affiliated participants shall be collectively deemed to be a single participant under proposed Rule 17Ad-22(b)(3) would be mandatory for all clearing agencies that provide CCP services.

d. Model Validation

The collection of information relating to providing for an annual model validation consisting of evaluating the performance of the clearing agency's margin models and the related parameters and assumptions associated with such models by a qualified person who does not perform functions associated with the clearing agency's margin models (except as part of the annual model validation) and does not report to a person who performs these functions under proposed Rule 17Ad-22(b)(4) would be mandatory for all clearing agencies that provide CCP services.

e. Non-Dealer Access

The collection of information relating to providing the opportunity for a person that does not perform any dealer or security-based swap dealer services to obtain membership at the clearing agency to clear securities for itself or on behalf of other persons under proposed Rule 17Ad-22(b)(5) would be mandatory for all clearing agencies that provide CCP services.

f. Net Capital Requirements

The collection of information relating to providing the opportunity for a person that maintains net capital equal to or greater than $50 million with the ability to obtain membership at the clearing agency, with any net capital requirements being scalable so that they are proportional to the risks posed by the participant's activities to the clearing agency; provided, however, that the clearing agency may provide for a higher net capital requirement as a condition for membership at the clearing agency if the clearing agency demonstrates to the Commission that such a requirement is necessary to mitigate risks that could not otherwise be effectively managed by other measures and the Commission approves the higher net capital requirement as part of a rule filing or clearing agency registration application under proposed Rule 17Ad-22(b)(7) would be mandatory for all clearing agencies that provide CCP services.

g. Record of Financial Resources

The collection of information each fiscal quarter, or at any time upon request by the Commission, relating to the calculation and maintenance of a record of the financial resources necessary to meet the requirements of proposed Rule 17Ad-22(b)(3) under proposed Rule 17Ad-22(c)(1) would be mandatory for all clearing agencies that perform CCP services.

h. Annual Audited Financial Report

The collection of information relating to the annual audited financial report that shall (i) be a complete set of financial statements of the clearing agency for the most recent two fiscal years and be prepared in accordance with U.S. GAAP, except that for a clearing agency that is a corporation or other organization incorporated or organized under the laws of any foreign country the financial statements may be prepared according to U.S. GAAP or IFRS; (ii) be audited in accordance with standards of the Public Company Accounting Oversight Board by a registered public accounting firm that is qualified and independent in accordance with Rule 2-01 of Regulation S-X (17 CFR 210.2-01); and (iii) include a report of the registered public accounting firm that complies with paragraphs (a) through (d) of Rule 2-02 of Regulation S-X (17 CFR 210.2-02) under proposed Rule 17Ad-22(c)(2) would be mandatory for all clearing agencies.

i. Transparent and Enforceable Rules and Procedures

The collection of information relating to policies and procedures providing for a well founded, transparent, and enforceable legal framework for each aspect of its activities in all relevant jurisdictions under proposed Rule 17Ad-22(d)(1) would be mandatory for all clearing agencies.

j. Participation Requirements

The collection of information relating to requiring participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the clearing agency; have procedures in place to monitor that participation requirements are met on an ongoing basis; and have participation requirements that are objective, publicly disclosed, and permit fair and open access under proposed Rule 17Ad-22(d)(2) would be mandatory for all clearing agencies.

k. Identification and Mitigation of Custody of Assets and Investment Risk

The collection of information relating to holding assets in a manner whereby risk of loss or of delay in its access to them is minimized; and investing assets in instruments with minimal credit, market and liquidity risks under proposed Rule 17Ad-22(d)(3) would be mandatory for all clearing agencies.

l. Identification and Mitigation of Operational Risk

The collection of information relating to identifying sources of operational risk and minimizing them through the development of appropriate systems, controls, and procedures; implementing systems that are reliable, resilient and secure, and have adequate, scalable capacity; and having business continuity plans that allow for timely recovery of operations and fulfillment of a clearing agency's obligations under proposed Rule 17Ad-22(d)(4) would be mandatory for all clearing agencies.

m. Money Settlement Risks

The collection of information relating to employing money settlement arrangements that eliminate or strictly limit the clearing agency's settlement bank risks, that is, its credit and liquidity risks from the use of banks to effect money settlements with its participants; and requiring funds transfers to the clearing agency to be final when effected under proposed Rule 17Ad-22(d)(5) would be mandatory for all clearing agencies.

n. Cost-Effectiveness

The collection of information relating to being cost-effective in meeting the requirements of participants while maintaining safe and secure operations under proposed Rule 17Ad-22(d)(6) would be mandatory for all clearing agencies.

o. Links

The collection of information relating to evaluating the potential sources of risk for any link arrangements the clearing agency establishes and prudently managing those risks under proposed Rule 17Ad-22(d)(7) would be mandatory for all clearing agencies.

p. Governance

The collection of information relating to having governance arrangements that are clear and transparent to fulfill the public interest requirements in Section 17A of the Exchange Act applicable to clearing agencies, to support the objectives of owners and participants, and to promote the effectiveness of the clearing agency's risk management procedures under proposed Rule 17Ad-22(d)(8) would be mandatory for all clearing agencies.

q. Information on Services

The collection of information relating to providing market participants with sufficient information for them to identify and evaluate the risks and costs associated with using its services under proposed Rule 17Ad-22(d)(9) would be mandatory for all clearing agencies.

r. Immobilization and Dematerialization of Stock Certificates

The collection of information relating to immobilization and dematerialization of securities certificates and transferring them by book entry to the greatest extent possible under proposed Rule 17Ad-22(d)(10) would be mandatory for all clearing agencies that perform central securities depository services.

s. Default Procedures

The collection of information relating to making key aspects of the clearing agency's default procedures publicly available and establishing default procedures that ensure that the clearing agency can take timely action to contain losses and liquidity pressures and to continue meeting its obligations in the event of a participant default under proposed Rule 17Ad-22(d)(11) would be mandatory for all clearing agencies.

t. Risk Controls to Address Participants' Failure to Settle

The collection of information relating to instituting risk controls including collateral requirements and limits to cover the clearing agency's credit exposure to each participant exposure fully, and that ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle when the clearing agency provides central securities depository services and extends intraday credit to participants, provided that if a participant controls another participant or is under common control with another participant then the affiliated participants shall be collectively deemed to be a single participant, under proposed Rule 17Ad-22(d)(14) would be mandatory for all clearing agencies.

u. Identification and Management of Physical Delivery Risks

The collection of information relating to stating to participants the clearing agency's obligations with respect to physical deliveries and identifying and managing the risks from those obligations under proposed Rule 17Ad-22(d)(15) would be mandatory for all clearing agencies.

2. Dissemination of Pricing and Valuation Information by Security-Based Swap Clearing Agencies that Perform Central Counterparty Services

The collection of information relating to the dissemination of pricing and valuation information of security-based swaps under proposed Rule 17Aj-1 would be mandatory for all security-based swap clearing agencies that perform CCP services.

3. Clearing Agency Policies and Procedures to Protect the Confidentiality of Trading Information of Clearing Agency Participants

The collection of information relating to the establishment, maintenance and enforcement of written policies and procedures under proposed Rule 17Ad-23 pertaining to the confidentiality of trading information would be mandatory for all clearing agencies.

4. Clearing Agency Procedures to Identify and Address Conflicts of Interest

The collection of information relating to the establishment, implementation, maintenance and enforcement of written policies and procedures reasonably designed to identify and address conflicts of interest under proposed Rule 17Ad-25 would be mandatory for all clearing agencies.

5. Standards for Board or Board Committee Directors

The collection of information relating to board or board committee directors governance standards under proposed Rule 17Ad-26 would be mandatory for all clearing agencies.

6. Designation of Chief Compliance Officer

The collection of information relating to the CCO under proposed Rule 3Cj-1 requirements would be mandatory for all clearing agencies.

F. Confidentiality

1. Standards for Clearing Agencies

a. Measurement and Management of Credit Exposures

The collection of information relating to the measurement and management of credit exposures under proposed Rule 17Ad-22(b)(1) would be provided to the Commission staff but not subject to public availability.

b. Margin Requirements

The collection of information relating to margin requirements under proposed Rule 17Ad-22(b)(2) would be provided to the Commission staff but not subject to public availability.

c. Financial Resources

The collection of information relating to financial resources under proposed Rule 17Ad-22(b)(3) would be provided to the Commission staff but not subject to public availability.

d. Model Validation

The collection of information relating to conducting an annual model validation under proposed Rule 17Ad-22(b)(4) would be provided to the Commission staff but not subject to public availability.

e. Non-Dealer Access

The collection of information relating to non-dealer access under proposed Rule 17Ad-22(b)(5) would be provided to the Commission staff but not subject to public availability.

f. Net Capital Requirements

The collection of information relating to the procedures for net capital requirements under proposed Rule 17Ad-22(b)(7) would be provided to the Commission staff but not subject to public availability.

g. Record of Financial Resources

The collection of information relating to the calculation and maintenance by a clearing agency that provides CCP services of a quarterly report describing the financial resources necessary to meet the requirements of proposed Rule 17Ad-22(b)(3) would be provided to the Commission staff under proposed Rule 17Ad-22(c)(1) but would not be subject to public availability.

h. Annual Audited Financial Report

The collection of information relating to the annual audited financial report published to the clearing agency's website under proposed Rule 17Ad-22(c)(2) would be subject to public availability.

i. Transparent and Enforceable Rules and Procedures

The collection of information relating to a clearing agency's well founded, transparent and enforceable legal framework under proposed Rule 17Ad-22(d)(1) would be provided to the Commission staff but not subject to public availability.

j. Participation Requirements

The collection of information relating to the procedures for monitoring and publicly disseminating the participation requirements under proposed Rule 17Ad-22(d)(2) would be provided to the Commission staff and would be subject to public availability.

k. Custody of Assets and Investment Risk

The collection of information relating minimizing custody and investment risk under proposed Rule 17Ad-22(d)(3) would be provided to the Commission staff but not subject to public availability.

l. Identification and Mitigation of Operational Risk

The collection of information relating to identifying and minimizing operational risk under proposed Rule 17Ad-22(d)(4) would be provided to the Commission staff but not subject to public availability.

m. Money Settlement Risks

The collection of information relating to the procedures for money settlement arrangements under proposed Rule 17Ad-22(d)(5) would be provided to the Commission staff but not subject to public availability.

n. Cost-Effectiveness

The collection of information relating to being cost-effective under proposed Rule 17Ad-22(d)(6) would be provided to the Commission staff but not subject to public availability.

o. Links

The collection of information relating to evaluating potential sources of risk in links arrangements under proposed Rule 17Ad-22(d)(7) would be provided to the Commission staff but not subject to public availability.

p. Governance

The collection of information relating to a clearing agency's governance arrangements under proposed Rule 17Ad-22(d)(8) would be provided to the Commission staff but not subject to public availability.

q. Information on Services

The collection of information relating to the provision of sufficient information to market participants under proposed Rule 17Ad-22(d)(9) would be provided to the Commission staff and market participants but not subject to public availability.

r. Immobilization and Dematerialization of Stock Certificates

The collection of information relating to the procedures for immobilizing and dematerializing stock certificates under proposed Rule 17Ad-22(d)(10) would be provided to the Commission staff but not subject to public availability.

s. Default Procedures

The collection of information relating to the establishment and maintenance of default procedures under proposed Rule 17Ad-22(d)(11) would be subject to public availability.

t. Risk Controls to Address Participants' Failure to Settle

The collection of information relating to risk controls to address participants' failure to settle under proposed Rule 17Ad-22(d)(14) would be provided to the Commission staff, but not subject to public availability.

u. Identification and Management of Physical Delivery Risks

The collection of information relating to the statement and management of physical delivery risk under proposed Rule 17Ad-22(d)(15) would be provided to the Commission staff, but not subject to public availability.

2. Dissemination of Pricing and Valuation Information by Security-Based Swap Clearing Agencies that Perform Central Counterparty Services

The collection of information relating to the dissemination of pricing and valuation information under proposed Rule 17Aj-1 would be subject to public availability.

3. Clearing Agency Policies and Procedures to Protect the Confidentiality of Trading Information of Clearing Agency Participants

The collection of information pertaining to the establishment, maintenance and enforcement of written policies and procedures pertaining to the confidentiality of trading information under proposed Rule 17Ad-23 would be provided to the Commission staff and would be subject to public availability.

4. Clearing Agency Procedures to Identify and Address Conflicts of Interest

The collection of information relating to the establishment, implementation, maintenance and enforcement of written policies and procedures reasonably designed to identify and address conflicts of interest under proposed Rule 17Ad-25 would be provided to the Commission staff and would be subject to public availability.

5. Standards for Board or Board Committee Directors

The collection of information relating to board or board committee directors governance standards under proposed Rue 17Ad-26 would be provided to the Commission staff and would be subject to public availability.

6. Designation of Chief Compliance Officer

The collection of information relating to the CCO under proposed Rule 3Cj-1would be provided to the Commission staff and would be subject to public availability.

G. Retention Period of Recordkeeping Requirements

Registered clearing agencies will be required to retain all correspondence and other communications reduced to writing (including comment letters) to and from such clearing agency for a period of not less than five years, the first two years of which are to be in a place immediately available to the Commission staff for inspection and examination, pursuant to the recordkeeping requirements set forth in Rule 17a-1 of the Exchange Act.

H. Request for Comment

The Commission invites comments on all of the above estimates. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission requests comment in order to: (a) evaluate whether the collection of information is necessary for the proper performance of our functions, including whether the information will have practical utility; (b) evaluate the accuracy of our estimate of the burden of the collection of information; (c) determine whether there are ways to enhance the quality, utility and clarity of the information to be collected; and (d) evaluate whether there are ways to minimize the burden of the collection of information on those who respond, including through the use of automated collection techniques or other forms of information technology.

Persons submitting comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and

Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should also send a copy of their comments to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, with reference to File No. S7-8-11. Requests for materials submitted to OMB by the Commission with regard to this collection of information should be in writing, with reference to File No. S7-8-11, and be submitted to the Securities and Exchange Commission, Office of Investor Education and Advocacy, 100 F Street, NE, Washington, DC 20549-0213. As OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

VI. Consideration of Costs and Benefits[279]

The Commission is proposing several new rules that would set standards for the operation and governance of clearing agencies. In part, the Dodd-Frank Act is intended to promote financial stability in the financial system of the United States by improving accountability and transparency.[280] Key aspects of the framework of the Dodd-Frank Act specifically give the Commission authority to regulate security-based swaps[281] and to prescribe regulations containing risk management standards for designated clearing entities that the Commission regulates. In addition to considering these specific concerns in formulating the proposed rules, the Commission believes that designing several of the proposed rules to be

279 The hourly rates use for professionals used throughout this Section VI. Consideration of Costs and Benefits are taken from the Securities Industry and Financial Markets Association's Management & Professional Earnings in the Securities Industry 2010, modified by the Commission's staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

280 See supra note 2.

281 See supra note 3.

applicable to all clearing agencies promotes financial stability by facilitating prompt and accurate clearance and settlement of securities transactions consistent with Section 17A of the Exchange Act while concurrently promoting the Dodd-Frank Act's stated aims of accountability and transparency.

Proposed Rules 17Ad-22 through 17Ad-26 and 3Cj-1 would establish operational standards for registered clearing agencies and require those clearing agencies to adopt written policies and procedures pertaining to, among other matters, the confidential treatment of trading information received by the clearing agency, identifying and addressing conflicts of interest, establishing board governance standards and designating a CCO for the clearing agency. Proposed Rule 17Aj-1 would require the public dissemination of certain pricing and valuation information by clearing agencies that perform CCP services with respect to security-based swaps. Finally, the proposed amendments to existing Rule 17Ab2-1 would modify the temporary registration process for clearing agencies.

The Commission is sensitive to the costs and benefits imposed by its rules and has identified the following costs and benefits. In particular, the discussion below is focused on the costs and benefits flowing from the decisions proposed by the Commission to fulfill the mandates of the Dodd-Frank Act rather than the mandates of the Dodd-Frank Act itself. However, to the extent that the Commission's discretion is aligned to take full advantage of the benefits intended by the Dodd Frank Act, the two types of benefits are not entirely separable. The Commission requests that commenters provide data and any other information or statistics on which they relied on to reach any conclusions.

A. Standards for Clearing Agencies

The standards set forth under proposed Rule 17Ad-22 build off of the recommendations of the CPSS-IOSCO RSSS and RCCP, adjusted to conform to the U.S. system for clearing agency regulation and to adopt those tailored standards as rule requirements. Included in this proposed rule is the requirement that each fiscal quarter (based on calculations made as of the last business day of the clearing agency's fiscal quarter), or at any time upon Commission request, a clearing agency that performs central counterparty services shall calculate and maintain a record of the financial resources necessary to comply with proposed Rule 17Ad-22(b)(3), as well as sufficient documentation to explain the methodology it uses to compute such financial resource requirement.

1. Benefits

The proposed standards are intended to provide benefits to clearing agencies and the markets they serve by promoting implementation of measures that would enhance the safety and efficiency of clearing agencies and reduce systemic risk. Safe and reliable clearing agencies are essential not only for the stability of the securities markets they serve but often also to payment systems, which may be used by a clearing agency or may themselves use a clearing agency to transfer collateral. The safety of securities settlement arrangements and post-trade custody arrangements is also critical to the goal of protecting the assets of investors from claims by creditors of intermediaries and other entities that perform various functions in the operation of the clearing agency.

Permitting persons who do not provide dealer or security-based swap dealer services to become members of a clearing agency, as required under proposed Rule 17Ad-22(b)(5), should foster the development of correspondent clearing arrangements that would allow dealers and security-based swap dealers, who may otherwise not be able to meet reasonable participation standards of a clearing agency, to obtain access to the clearing agency through correspondent clearing arrangements, thereby increasing competition among clearing agencies. The net capital requirements contained in proposed Rule 17Ad-22(b)(7) would help remove an overly burdensome barrier to clearing agency access for market participants with a net capital level of at least $50 million, and promote greater direct access to clearing agencies. Entities that become participants will also benefit from an elimination of fee costs that the entities might otherwise have incurred to gain indirect access to the clearing agency through existing participants with higher levels of net capital. Proposed Rule 17Ad-22(b)(7) also may facilitate greater competition among market participants of varying sizes because smaller market participants may not incur additional cost to clear and settle transactions.

Finally, the standards in proposed Rule 17Ad-22(d) have the potential to mitigate various risks associated with providing clearing agency services by establishing standards to address (1) transparent and enforceable rules and procedures; (2) participation requirements; (3) custody of assets and investment risk; (4) operational risk; (5) money settlement risk; (6) cost-effectiveness; (7) links; (8) governance; (9) information on services; (10) immobilization and dematerialization of stock certificates; (11) default procedures; (12) timing of settlement finality; (13) delivery versus payment; (14) risk controls to address participants' failures to settle; and (15) physical delivery risks. This should help to create a framework for the operation of clearing agencies that would promote sound and efficient practices by the clearing agency. Moreover, standards relating to measurement and management of credit exposures, margin requirements, and financial resources should act as a helpful tool to manage systemic risk as increasing amounts of clearance and settlement activity is centralized within clearing agencies. At the same time, requiring annual evaluations of the performance of the clearing agency's margin models should help to ensure that clearing agencies' margin models perform in a manner that facilitates prompt and accurate clearance and settlement of transactions.

2. Costs

As noted above, the standards contained in proposed Rules 17Ad-22(b)(1), (2), (3), (4), (5), (6), (7), (c)(1), (2), (d)(1), (2), (3), (4), (5), (6), (7), (8), (9), (10), (11), (12), (13), (14) and (15) would impose certain burdens and related costs on respondent clearing agencies. As discussed in section V.D.1., based on policies and procedures requirements for Regulation NMS and security-based swap data repositories and based on staff conversations with industry representatives, the Commission has estimated the burdens and related costs of these requirements for clearing agencies.

The proposed clearing agency standards in proposed Rules 17Ad-22(b)(1), (2), (3), (4), (5), (6), (7) , (c)(1), (2), (d)(1), (2), (3), (4), (5), (6), (7), (8), (9), (10), (11), (12), (13), (14) and (15) would require respondent clearing agencies to create policies and procedures. The requirements would impose one-time costs of approximately $26,084,488 in the aggregate for all respondent clearing agencies.[282] The standards contained in proposed Rules 17Ad-22(b)(4), (c)(2), (d)(2), (8), (9), (11) and (15) would also impose one-time costs on clearing agencies that are related to the adjustment of systems. With respect to proposed Rules 17Ad-22(b)(2), (d)(2), (8), (9), (11) and (15), this adjustment would be related to facilitating compliance with requirements to provide information or make information available. Proposed Rule 17Ad-

[282] This figure was calculated as follows: ((Assistant General Counsel for 87 hours at $430 per hour) + (Compliance Attorney for 77 hours at $320 per hour) + (Computer Operations Department Manager for 23 hours at $367 per hour) + (Senior Business Analyst for 23 hours at $232 per hour)) = $75,827 x 16 standards pursuant to proposed Rules 17Ad-22(d)(1), (2), (3), (4), (5), (6), (7), (8), (9), (10), (11), (14), (15) and (c)(2) = $1,213,232 x 17 respondent clearing agencies = $20,624,944) + (($75,827 x 8 standards pursuant to proposed Rules 17Ad-22(b)(1), (2), (3), (4), (5), (6), (7) and (c)(1) = $606,616 x 9 clearing agencies = 5,459,544) = $26,084,488. See supra note 195.

22(b)(4) would require one-time systems adjustments related to the capability to perform an annual model validation. These adjustments would amount to a one-time cost of approximately $4,182,480 in the aggregate for all respondent clearing agencies.[283] Consequently, this results in a total one-time burden imposed by proposed Rule 17Ad-22 of approximately $30,266,968 in the aggregate for all respondent clearing agencies.[284]

The standards contained in Rule 17Ad-22 would also impose ongoing costs on clearing agencies. For example, the proposed clearing agency standards in proposed Rules 17Ad-22(b)(1), (2), (3), (4), (5), (6), (7), (c)(1), (2), (d)(1), (2), (3), (4), (5), (6), (7), (8), (9), (10), (11), (14) and (15) would collectively require respondent clearing agencies to perform certain ongoing monitoring and enforcement activities with respect to the policies and procedures the clearing agency creates in response to the proposed standard. Accordingly, the Commission preliminarily believes that those ongoing activities would impose total annual costs of approximately $6,660,800 in the aggregate for all respondent clearing agencies.[285]

Proposed Rule 17Ad-22(b)(4) would entail ongoing costs. To meet the requirements of the proposed Rule 17Ad-22(b)(4) to provide for an annual model validation, the Commission

283 This figure was calculated as follows: ((Chief Compliance Officer for 40 hours at $423 per hour) + (Computer Department Operations Manager for 40 hours at $367 per hour) + (Senior Programmer for 20 hours at $304 per hour) = $37,680 x proposed Rules 17Ad-22(d)(2), (8), (9), (11), (15) and (d)(2)) = $226,080 x 17 respondent clearing agencies = $3,843,360 + ($37,680 x 9 clearing agencies for proposed Rules 17Ad-22(b)(4) = $339,120) = $4,182,480. See supra note 253.

284 This $30,266,968 figure is the sum of the one-time costs calculated in note 282, $26,084,488, plus the one-time costs calculated in note 283, $4,182,480.

285 This figure was calculated as follows: ((Compliance Attorney for 60 hours at $320 per hour = $19,200 x 16 standards pursuant to proposed Rules 17Ad-22(d)(1), (2), (3), (4), (5), (6), (7), (8), (9), (10), (11), (12), (13), (14), (15) and (c)(2) = $307,200 x 17 respondent clearing agencies = $5,222,400) + ($19,200 x 8 standards pursuant to proposed Rules 17Ad-22(b)(1), (2), (3), (4), (5), (6), (7) and (c)(1) = $153,600 x 9 clearing agencies = $1,382,400)) = $6,660,800. See supra note 196.

preliminarily believes clearing agencies would hire a consulting firm that dedicates two consultants to the project. The Commission estimates that this requirement would impose an ongoing annual cost of approximately $432,000 for each respondent, which corresponds to a total annual cost of approximately $7,776,000 in the aggregate for all respondent clearing agencies.[286]

Proposed Rule 17Ad-22(b)(6) would impose ongoing costs on the nine estimated clearing agencies that provide CCP services. The rule would impose these ongoing costs to the extent that staff from the legal, compliance, risk or other departments at the clearing agency providing CCP services would be responsible for ensuring that the clearing agency's membership standards do not require participants to maintain a portfolio of a minimum size or to maintain a minimum transaction volume threshold. This gate-keeping responsibility required in Rule 17Ad-22(b)(6) is unlikely to require the complete work hours of a full-time employee. Instead, as an ongoing cost related to preventing these specific types of participation standards, the cost would likely represent a fraction of total staff time and related costs. Based on the Commission's experience regulating clearing agencies that provide CCP services, it is unlikely that such a clearing agency would frequently seek to change its membership requirements in a way that would be inconsistent with proposed Rule 17Ad-22(b)(6). Therefore, the fractional cost imposed on the clearing agency by the proposed rule would likely be small compared to the clearing agency's overall cost of paying the same staff to perform their other job responsibilities.

In addition, proposed Rule 17Ad-22(b)(7) may require a clearing agency that provides CCP services to update its policies and procedures relating to its net capital requirements if it

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286 This figure was calculated as follows: 2 Consultants for 30 hours per week at $600 per hour = $36,000 per week x 12 weeks = $432,000 per clearing agency x 9 clearing agencies = $7,776,000.

determines that the clearing agency should provide for a higher net capital requirement (i.e., higher than $50 million) as a condition for membership. This work would entail the preparation of potentially one new policy annually reflecting the clearing agency's updated net capital requirements. To meet these ongoing requirements of proposed Rule 17Ad-22(b)(7), the Commission preliminarily estimates a total annual cost of $682,443 in the aggregate for all respondent clearing agencies.[287] The proposed rule's requirement that a clearing agency that provides CCP services must provide a person with net capital equal to or greater than $50 million with the ability to obtain membership at the clearing agency (with any net capital requirements being scalable so that they are proportional to the risks posed to the clearing agency by the participant's activities) would also impose costs on the operations of the clearing agency. Specifically, certain clearing agencies that provide CCP services would likely need to revise their admission criteria so that they are scalable and still provides for effective measures to limit the risks that smaller members present to the clearing agency. This would involve implementation and oversight of any measures such as heightened margin requirements, limited access to clearing services, portfolio and transaction requirements, or other risk management measures used as part of the scalable membership classes that would be designed by the clearing agency under the proposed rule.

The requirements in proposed Rules 17Ad-22(c)(1) and (2) would also impose ongoing costs on clearing agencies. Under proposed Rule 17Ad-22(c)(1), the requirement for a clearing agency that provides CCP services to calculate and maintain a record of the financial resources

287 This figure was calculated as follows: ((Assistant General Counsel for 87 hours at $430 per hour) + (Compliance Attorney for 77 hours at $320 per hour) + (Computer Operations Department Manager for 23 hours at $367 per hour) + (Senior Business Analyst for 23 hours at $232 per hour)) = $75,827 x 1 new policy annually in response to Rule 17Ad-22(b)(7) = $75,827 x 9 respondent clearing agencies = $682,443. See supra note 195.

necessary to meet the requirements of proposed Rule 17Ad-22(b)(3), as well as sufficient documentation to explain the methodology it uses to compute such financial resource requirement, would require the efforts of clearing agency compliance and operational personnel to create the reports, properly document them and ensure the reports and supporting documentation are properly record kept. To meet these ongoing requirements of proposed Rule 17Ad-22(c)(1), the Commission preliminarily estimates a total annual cost of $37,944.[288]

Proposed Rule 17Ad-22(c)(2) would require each clearing agency to post on its website an annual audited financial report. Each financial report would have to (i) be a complete set of financial statements of the clearing agency for the most recent two fiscal years and be prepared in accordance with U.S. GAAP, except that for a clearing agency that is a corporation or other organization incorporated or organized under the laws of any foreign country the financial statements may be prepared according to U.S. GAAP or IFRS as issued by the International Accounting Standards Board; (ii) be audited in accordance with standards of the Public Company Accounting Oversight Board by a registered public accounting firm that is qualified and independent in accordance with Rule 2-01 of Regulation S-X (17 CFR 210.2-01); and (iii) include a report of the registered public accounting firm that complies with paragraphs (a) through (d) of Rule 2-02 of Regulation S-X (17 CFR 210.2-02). This requirement would necessitate work hours of compliance personnel and finance personnel at the clearing agency to compile relevant data, organize and analyze that data, and then post it to the clearing agency's website consistent with the rule. The requirement would also require the services of a registered public accounting firm. The Commission estimates those services would cost approximately

288 This figure was calculated as follows (Compliance Attorney for 1 hour at $320 per hour) + (Computer Operations Department Manager for 2 hours at $367)) = $1,054 per quarter x 4 quarters per year = $4216 per year x 9 clearing agencies = $37,944.

$500,000 annually. Therefore, to meet the ongoing requirements of proposed Rule 17Ad-22(c)(2) the Commission estimates a total annual cost of approximately $10,239,984 in the aggregate for all respondent clearing agencies.[289]

Consequently, this results in a total, annual burden imposed by proposed Rule 17Ad-22 of approximately $25,397,171.[290]

Recent assessments of the registered U.S. clearing agencies support the conclusion that these entities generally meet or exceed analogous standards of operation and governance to those that are contained within Rule 17Ad-22. Those findings support a view that the requirements of proposed Rule 17Ad-22 would not be likely to require the clearing agencies to build new infrastructure or modify operations to continue to meet the standards.[291] The Commission's oversight of the entities clearing CDS pursuant to the CDS Clearing Exemption Orders forms the basis for a similar belief that no associated start-up costs would be imposed because those entities already represent through the CDS Clearing Exemption Orders that they meet the CPSS-

289 This figure was calculated as follows: ((Senior Accountant for 500 hours at $198 per hour) + (Senior Systems Analyst for 8 hours at $259 per hour) + (Compliance Attorney for 4 hours at $320) = $102,352 + $500,000 for independent public accounting services = $602,352 x 17 respondent clearing agencies = $10,239,984. <u>See</u> <u>supra</u> notes 192 and 193.

290 This $25,397,171 figure is the sum of the aggregate annual costs estimated in note 285, $6,660,800, plus the aggregate annual cost estimated in note 286, $7,776,000, plus the aggregate cost estimated in note 287, $682,443, plus the aggregate annual cost estimated in note 288, $37,944, plus the aggregate annual cost estimated in note 289, $10,239,984.

291 <u>See generally</u> International Monetary Fund, Publication of Financial Sector Assessment Program Documentation – Detailed Assessment of Observance of the National Securities Clearing Corporation's Observance of the CPSS-IOSCO Recommendations for Central Counterparties 4-29 (2010), <u>available at</u> <u>http://www.imf.org/external/pubs/ft/scr/2010/cr10129.pdf</u>; International Monetary Fund, Publication of Financial Sector Assessment Program Documentation – Detailed Assessment of Observance of the Depository Trust Company's Observance of the CPSS-IOSCO Recommendations for Securities Settlement Systems 4-40 (2010), <u>available at</u> <u>http://www.imf.org/external/pubs/ft/scr/2010/cr10128.pdf</u>.

IOSCO standards for central counterparties, which impose similar requirements to those contained in proposed Rule 17Ad-22.

B. Dissemination of Pricing and Valuation Information by Security-Based Swap Clearing Agencies that Perform Central Counterparty Services

The Commission is proposing new Rule 17Aj-1 which would require every security-based swap clearing agency that performs CCP services to make available to the public all end-of-day settlement prices and any other prices with respect to security-based swaps that it may establish to calculate mark-to-market[292] margin requirements for its participants. Proposed Rule 17Aj-1 would also require security-based swap clearing agencies that perform CCP services to make available to the public any other pricing or valuation information with respect to security-based swaps that it otherwise publishes or makes available to its participants. Under the proposed rule, this information is not required to be made available to the public free of charge. Instead, it must be provided to the public on terms that are fair, reasonable and not unreasonably discriminatory.

1. Benefits

Proposed Rule 17Aj-1 would provide a publicly available source of pricing and valuation information for pricing and valuation in the security-based swap markets. The Commission recognizes that other market mechanism created under the Dodd-Frank Act, such as security-based swap data repositories and security-based swap execution facilities, will also generate security-based swap pricing data. Under the Dodd-Frank Act, all security-based swap transactions are required to be reported to a security-based swap data repository, or, if such data

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292 See supra note 91 (explaining the specific meaning of "mark-to-market" in the context of the margin practices of security-based swap clearing agency margin practices).

repository does not exist, to the Commission.[293] Consequently, security-based swap data repositories would consolidate post-trade information about security-based swaps that the Commission preliminarily believes would be helpful for analyzing the security-based swap market as a whole and identifying its risks.[294] Similarly, security-based swap execution facilities will provide important pre-trade information about security-based swaps.

However, the Commission preliminarily believes that pricing and valuation information generated by clearing agencies would add value beyond pre- and post- trade pricing information. Rather than basing risk management of clearance and settlement on pre or post trade pricing that may be stale, or may be inappropriate to facilitate a clearing agency's risk management practices for other reasons, clearing agencies frequently generate their own prices for security-based swaps, either through consensus pricing or pricing models. Those prices are then used to inform the clearing agency's margin requirements for its participants and the risk management of the clearing facility.

End-of-day pricing information is pricing during the life of a security-based swap that is not otherwise available from pre- and post- trade market sources—for instance from a security-based swap execution facility or security-based swap data repository. Therefore, the Commission preliminarily believes public availability of the end-of-day pricing information, as well as any other pricing information the security-based swap clearing agency publishes or

293 See Pub. L. No. 111-203, §§ 763(i) and 766(a) (adding Exchange Act Sections 13(m)(1)(G) and 13A(A)(1), respectively). The Dodd-Frank Act amends the CEA to provide for a similar regulatory framework with respect to transactions in swaps regulated by the CFTC.

294 See Exchange Act Release No. 63347 (November 19, 2010), 75 FR 77306 (December 10, 2010) (discussing in Section II, Role, Regulation, and Business Models of SDRs, that the enhanced transparency provided by an SDR is important to help regulators and others monitor the build-up and concentration of risk exposures in the security-based swaps market).

distributes with respect to security-based swaps can provide helpful transparency to market participants about the value of similar security-based swap positions they may hold. Accordingly, the Commission preliminarily believes that requiring the information to be made publicly available on terms that are fair, reasonable and not unreasonably discriminatory improves fairness, efficiency, and market competition by providing availability to data that may otherwise be difficult for some market participants to obtain.

2. Costs

The proposed rule requiring dissemination of pricing and valuation information would impose initial and ongoing costs on security-based swap clearing agencies. To establish the necessary pricing and valuation infrastructure to satisfy Rule 17Aj-1, security-based swap clearing agencies that perform CCP services would bear the cost of establishing the applicable infrastructure capabilities. The Commission notes that entities providing CCP services for security-based swaps are currently required by the CDS Clearing Exemption Orders to disseminate pricing and valuation information.

As noted above in section V.D.2., based on staff conversations with industry representatives already subject to similar requirements under the CDS Clearing Exemption Orders, the Commission preliminarily estimates that the one-time burden for a security-based swap clearing agency that performs CCP services to comply with the requirements of proposed Rule 17Aj-1 would only involve adjustments to computing systems required as part of registration. The Commission estimates that for a clearing agency to adjust its systems beyond the specifications associated with registration would impose a one-time cost of approximately

$37,680 on each respondent clearing agency, corresponding to a total one-time aggregate cost imposed on all respondent clearing agencies of approximately $226,080.[295]

To meet the requirements of the proposed rule, security-based swap clearing agencies that perform CCP services would have a continuous responsibility to make the relevant pricing and valuation information available. The Commission estimates this imposes an ongoing annual aggregate burden of $22,020 for each respondent, which corresponds to an ongoing aggregate annual cost of $132,120 for all respondent clearing agencies.[296]

C. Clearing Agency Policies and Procedures to Protect the Confidentiality of Trading Information of Clearing Agency Participants

Proposed Rule 17Ad-23 would require each registered clearing agency to establish, maintain and enforce written policies and procedures designed to protect the confidentiality of any and all transaction information that the clearing agency receives. Such transaction information may include, but is not limited to, trade data, position data, and any non-public personal information about a clearing agency member or participant or any of its members or participant's customers. The proposed rule also provides that the required policies and procedures shall include, but are not limited to, (a) limiting access to confidential trading information of clearing members to those employees of the clearing agency who are operating the system or responsible for its compliance with any other applicable laws or rules and (b) standards controlling employees and agents of the clearing agency trading for their personal benefit or the benefit of others.

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295 This figure was calculated as follows: ((Chief Compliance Officer for 40 hours at $423) + (Computer Operations Department Manager for 40 hours at $367) + (Senior Programmer for 20 hours at $304)) = $37,680 dollars x 6 respondent clearing agencies = $226,080. See supra note 253.

296 This figure was calculated as follows: Computer Operations Department Manager for 60 hours at $367 dollars per hour = $22,020 x 6 security-based swap clearing agencies = $132,120. See supra note 254.

1. **Benefits**

The proposed standards are intended to promote implementation of adequate measures taken by a clearing agency to safeguard data, which can increase market participants' confidence in the safety and reliability of a clearing agency. Trade data stored by a clearing agency should be protected from loss, leakage, unauthorized access and other processing risks. It is necessary for a clearing agency to apply information security and system integrity objectives to its own operations to protect trade data during transmission and dissemination. These protections for trade data benefit participants by helping to ensure, for instance, that participant trade data is not leaked to other market participants who may attempt to use that information to front run participant trades or misappropriate it in other ways. Protections for trade data by a clearing agency also generate the benefit to participants of promoting the confidence among participants and their customers that use of a clearing agency to clear and settle trades will not result in economic or reputational harm to the clearing agency's users. This, in turn, promotes overall marketplace confidence in the clearance and settlement system for securities transactions.

2. **Costs**

Proposed Rule 17Ad-23 would impose costs on a clearing agency to establish procedures to protect the confidentiality of trading information of participants. However, the entities providing CCP services for security-based swaps pursuant to the CDS Clearing Exemption Orders already maintain and enforce safeguards to protect the confidentiality of trading information of participants as part of those orders. While the Commission notes that those respondents may not need to make additional, one-time changes to meet the requirements of proposed Rule 17Ad-23, the Commission is assuming for the purpose of this cost-benefit analysis that proposed Rule 17Ad-23 would impose one-time costs on them. As discussed above in section V.D.3., based on staff discussions with industry representatives already subject to similar requirements under the CDS Clearing Exemption Orders, the Commission has estimated the burdens and related costs of these requirements for clearing agencies.

The Commission does anticipate the rule would impose one-time costs at the remaining six clearing agencies related to the coordinated research and development costs between compliance, legal, operational, and information technology staff. Protecting confidential information in compliance with the requirements of the proposed rule would likely necessitate drawing on expertise and knowledge from each of these areas. The number of employees and number of employee hours required to deliver the necessary information could vary slightly between clearing agencies given that clearing agencies may divide the skill sets of their employees differently. However, for a clearing agency to create policies and procedures protecting the confidentiality of trading information of participants, the Commission believes the rule would impose a one-time cost on each clearing agency of approximately $227,290, corresponding to an aggregate one-time cost to all respondent clearing agencies of approximately $3,863,930.[297]

The rule would also impose ongoing costs associated with storing confidential data in the form and manner prescribed by the clearing agency's policies and procedures, which would be designed to control access to that information. Such costs are likely to include monitoring and testing of the integrity of the access controls on the data and potentially updating those controls as new technology becomes available or as the clearing agency modifies the safeguarding

297 This figure was calculated as follows ((Chief Compliance Officer for 210 hours at $423 per hour) + (Computer Operations Department Manager for 180 hours at $367 per hour) + (Senior Programmer for 180 hours at $304 per hour) + (Risk Management Specialist for 40 hours at $192 per hour) + ($10,000 software costs)) = $227,290 x 17 respondent clearing agencies = $3,863,930. <u>See</u> <u>supra</u> note 256.

requirements within the policies and procedures. The Commission believes these responsibilities would impose an ongoing annual cost per clearing agency of approximately $56,942, corresponding to an annual aggregate cost to all clearing agencies of approximately $7,990,544.[298]

D. Exemption from Clearing Agency Definition

The Commission is proposing new Rule 17Ad-24 which would exempt from the definition of clearing agency, as defined in Section 3(a)(23)(A) of the Exchange Act, certain registered security-based swap dealers and security-based swap execution facilities.

1. Benefits

The proposed rule described in this section would provide for the exclusion of certain registered security-based swap dealers and registered security-based swap execution facilities from the definition of a clearing agency. The proposed rule is intended to avoid subjecting these entities, where appropriate, to multiple registrations when doing so would impose overlapping or duplicative requirements with marginal benefits or no benefits to safeguarding securities and funds and protecting investors.

2. Costs

The Commission anticipates any costs associated with the proposed rule are likely to be minimal. Registered security-based swap dealers and registered security-based swap execution facilities that perform certain limited clearing agency functions could rely on the proposed exemption upon determining that their clearing agency functions are within the scope of the rule.

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298 This figure was calculated as follows: Compliance Attorney at 4 hours per business day x 260 business days per year = 1040 hours per year at $423 per hour + ((Computer Operations Department Manager for 40 hours per year at $367 per hour) + (Senior Programmer for 40 hours per year at $304 per hour) + (Senior Risk Management Specialist at 8 hours per year at $409 per hour)) = $470,032 x 17 respondent clearing agencies = $7,990,544. See supra note 258.

E. Amendment of 17Ab2-1 Registration of Clearing Agencies

Proposed Rule 17Ab2-1 would provide for amendments to Section 17Ab2-1 of the Exchange Act and extends certain timeframes associated with the registration of clearing agencies.

1. Benefits

A modernized temporary registration process can serve as a useful tool by giving the Commission the option to examine a clearing agency after it becomes operational, but in advance of its registration being final. For example, a newly formed security-based swap clearing agency may only be able to provide materials regarding its anticipated activities when completing its CA-1 registration form. However, there may be value in examining the security-based swap clearing agency once it becomes operational. This has the benefit of informing the Commission by observations made through examinations and/or monitoring of active operations.

2. Costs

The amendments to the Rule 17Ab2-1 relate specifically to the operations of the Commission and the timing of its ability to grant temporary registrations for clearing agencies. As a result, the Commission preliminarily believes that the proposed amendments to Rule 17Ab2-1 are unlikely to impose costs to clearing agencies other than those that currently exist.

F. Procedures to Identify and Address Conflicts of Interest

Proposed Rule 17Ad-25 would require registered clearing agencies to establish, implement, maintain and enforce written policies reasonably designed to identify and address existing or potential conflicts of interest and minimize conflicts of interest in decision-making at the clearing agency.

1. Benefits

Requiring a clearing agency to create written policies and procedures designed to identify conflicts of interest would help a clearing agency evaluate its particular organization and activities and determine areas that might undermine the clearing agency's core business of clearing and settling securities transactions. A documented plan provides a clear set of guidelines that can focus the clearing agency's evaluation and ensure consistency in the way those evaluations are performed. Similarly, if conflicts are identified, the policies and procedures offer a standard method of approaching those conflicts to make sure they are addressed. The procedures would also provide a documented plan against which the Commission could evaluate a clearing agency's efforts to mitigate conflicts and provide the Commission with a better understanding of those areas of operation and organization about which a clearing agency may be particularly concerned.

2. Costs

Creating written policies and procedures under proposed Rule 17Ad-25 that are reasonably designed to identify and address conflicts of interest would necessitate an evaluation by each clearing agency of the areas in its operation that are likely to be susceptible to conflicts of interest. This review is an exercise likely to require collaboration between the board of directors of the clearing agency and senior management given that many of the potential conflicts are likely to revolve around the participant admissions and voting rights practices of the clearing agency. After the review, the Commission anticipates that the compliance or legal staff of the clearing agency would be assigned to draft policies and procedures.

As discussed in section V.D.4., the Commission preliminarily believes that there are analogous policies and procedures requirements for Regulation NMS and in the proposed requirements for security-based swap data repositories that are informative of the burdens and related costs to clearing agencies under proposed Rule 17Ad-25. The Commission believes that the one-time cost to research and create the policies and procedures would be approximately $191,654 for each clearing agency, corresponding to a one-time aggregate cost to all clearing agencies of approximately $3,258,118.[299] Costs would also be incurred by the clearing agency to monitor and enforce the policies and procedures. The Commission preliminarily believes this would impose an annual cost of approximately $38,400 per clearing agency, corresponding to an annual aggregate burden to all clearing agencies of approximately $652,800.[300]

G. Standards for Board or Board Committee Directors

Proposed Rule 17Ad-26 would set forth governance standards that clearing agencies would be required to establish with respect to their board members and board committee directors. These standards would include at least the following areas: (i) a clear articulation of the roles and responsibilities of directors serving the clearing agency's board and any board committees; (ii) director qualifications providing criteria for expertise in the securities industry, clearance and settlement of securities transactions, and financial risk management; (iii) disqualifying factors concerning serious legal misconduct, including violations of the federal securities laws; and (iv) policies and procedures for the periodic review by the board or a board committee of the performance of its individual members.

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299 This figure was calculated as follows: ((Assistant General Counsel for 87 hours at $430 per hour) + (Compliance Attorney for 77 hours at $320 per hour) + (Computer Operations Department Manager for 23 hours at $367 per hour) + (Senior Business Analyst for 23 hours at $232 per hour)) = $75,827 x 2 policies and procedures + $40,000 in one-time outside legal costs = $191,654 x 17 respondent clearing agencies = $3,258,118. See supra notes 261 and 262.

300 This figure was calculated as follows: Compliance Attorney for 60 hours at $320 per hour = $19,200 x 2 policies and procedures = $38,400 x 17 respondent clearing agencies = $652,800. See supra note 263.

1. Benefits

Clearing agencies are at the heart of the settlement process. Moreover, because their activities are subject to significant economies of scale, many are sole providers of clearing and settlement services to the market they serve. Therefore, their performance is a critical determinant of the safety and efficiency of those markets. No single set of governance arrangements is appropriate for all clearing agencies within the various securities markets and regulatory schemes. However, an effectively governed clearing agency should meet certain key minimum requirements. Among these are delivering sound risk management; ensuring a clear separation between reporting lines for risk management and other clearing agency operations, meeting public interest requirements, identifying those principally responsible for achieving the clearing agencies governance objectives, and disclosing the extent to which these objectives have been met.

Requiring registered clearing agencies to establish standards for their board and board committee members helps to ensure that well-qualified individuals contribute to effective governance of a clearing agency. Board members who can provide guidance by drawing on expertise in the securities industry, clearance and settlement, and risk management are well positioned to make decisions that account for the positions of the various participants in the market the clearing agency serves as well as to balance those perspectives with the goals of stability and efficiency of the clearing agency. In the interest of promoting informed and balanced decision making in governance, requiring each clearing agency to establish governance standards that include disqualifying factors concerning serious legal misconduct, including violations of the federal securities laws, would help clearing agencies evaluate whether persons who have been found to have violated the securities laws, or other similar laws or statutes, may not be fit to serve on the clearing agency's board or board committees.

Proposed Rule 17Ad-26 would also benefit the clearing agency and its participants by creating a degree of certainty in the role and responsibility of each director and in defining instances appropriate for removal of a director. The requirement for a clear articulation of the role and responsibility of each director focuses the governance resources of the clearing agency and provides commonly understood boundaries with respect to what is expected of each director. Clearly articulating those expectations can help the directors understand how to make individual contributions to the governance of the clearing agency as well as the ways in which they are expected to work with one another to govern the clearing agency effectively.

Finally, requiring clearing agencies to establish policies and procedures for the periodic review by the board or a board committee of the performance of its individual members would support prompt and accurate clearance and settlement because directors play a vital role in the decision-making processes of the clearing agency. These reviews would promote focused analysis on the contributions that directors make to the clearing agency and how those contributions are particularly valuable or could be adjusted or improved to better support the clearing agency's ability to operate in effectively.

2. Costs

Proposed Rule 17Ad-26 would set forth governance standards applicable to a clearing agency's board members and board committee directors. The rule would require clearing agencies to adopt procedural frameworks that inform the governance of the clearing agency.

Proposed Rule 17Ad-26 would require a clearing agency to incur research and development costs associated with creating standards for its board members and board committee members. The Commission anticipates that there would likely need to be a coordinated effort between different business units within a clearing agency to develop these standards. As discussed in section V.D.5., the Commission preliminarily believes that there are analogous policies and procedures requirements for Regulation NMS and in the proposed requirements for security-based swap data repositories that are informative of the burdens and related costs for clearing agencies under proposed Rule 17Ad-26. The Commission believes that the one-time cost to a clearing agency imposed by the rule would be approximately $95,827, corresponding to a one-time aggregate cost to all clearing agencies of approximately $1,629,059.[301]

Also involved would be the time of the clearing agency's employees that would be devoted to maintaining application of the standards to the incumbent directors, evaluating new directors and evaluating the incumbent directors on an annual basis. For example, the Commission preliminarily believes that a compliance attorney at a clearing agency may be asked to update the clearing agency's standards to clearly reflect the roles and responsibilities of the clearing agency's directors. Similarly, time of a compliance attorney may be needed to amend the standards with respect to director qualifications and disqualifying factors for service if the clearing agency decides to make changes to those aspects of its governance standards. The Commission preliminarily believes that the annual cost to each clearing agency would be approximately $19,200, corresponding to an annual aggregate cost to all clearing agencies of

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301 This figure was calculated as follows: ((Assistant General Counsel for 87 hours at $430 per hour) + (Compliance Attorney for 77 hours at $320 per hour) + (Computer Operations Department Manager for 23 hours at $367 per hour) + (Senior Business Analyst for 23 hours at $232 per hour)) = $75,827 + $20,000 in one-time outside legal costs = $95,827 x 17 respondent clearing agencies = $1,629,059. See supra notes 266 and 267.

approximately $326,000.[302] In addition, the Commission preliminarily believes that third party facilitation of the annual review of the incumbent board members would also impose an ongoing annual cost of $6,000 for each respondent, which corresponds to a total annual cost of $102,000 in the aggregate for all respondent clearing agencies.[303] An employee at the clearing agency may be expected to help arrange and coordinate such a third-party review of the clearing agency's board members, which would also factor into the ongoing, annual cost to a clearing agency.

G. Proposed Rule 3Cj-1 Designation of Chief Compliance Officer

Proposed Rule 3Cj-1 would incorporate the requirements of Section 3Cj of the Exchange Act and impose additional requirements. Proposed Rule 3Cj-1 would require each registered clearing agency to designate a CCO. Under proposed Rule 3Cj-1(b), the CCO would be responsible for, among other matters, establishing policies and procedures for the remediation of non-compliance issues identified by the CCO and establishing and following appropriate procedures for the prompt handling of management response, remediation, retesting, and closing of non-compliance issues.

Under Proposed Rule 3Cj-1(c), the CCO would also be responsible for preparing and signing an annual compliance report that contains a description of (i) the compliance of the clearing agency with respect to the federal securities laws and the rules and regulations thereunder, and (ii) each policy and procedure of the clearing agency of the compliance officer (including the code of ethics and conflict of interest policies of the registered clearing agency). This compliance report must accompany each appropriate financial report of the clearing agency that is required to be furnished to the Commission pursuant to the Exchange Act and the rules

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302 This figure was calculated as follows: Compliance Attorney for 60 hours at $320 per hour = $19,200 x 17 respondent clearing agencies = $326,400. See supra note 268.

303 This figure was calculated as follows: One Consultant for 20 hours at $600 per hour = $12,000 x 17 respondent clearing agencies = $204,000. See supra note 269.

thereunder and include a certification that, under penalty of law, the compliance report is accurate and complete.

Additionally, the compliance report would be required to: (i) be submitted to the board of directors and audit committee (or equivalent bodies) of the clearing agency promptly after the date of execution of the required certification and prior to filing of the report with the Commission; (ii) be filed with the Commission in a tagged data format in accordance with the instructions contained in the EDGAR Filer Manual, as described in Rule 301 of Regulation S-T; and (iii) be filed with the Commission within 60 days after the end of the fiscal year covered by such report.

1. Benefits

Proposed Rule 3Cj-1 is designed to ensure that clearing agencies comply with federal securities laws, including the Exchange Act and the rules and regulations promulgated thereunder. Although entities currently operating as clearing agencies already may have CCOs in place, Section 3C(j) of the Exchange Act and proposed Rule 3Cj-1 would make it a required practice.

The designation of a CCO would help ensure that each clearing agency complies with the written policies and procedures it adopts. The Commission expects requiring this safeguard would in turn facilitate accurate data reporting by clearing agencies to the Commission and improve the Commission's understanding of operations across all the clearing agencies it oversees.

Proposed Rule 3Cj-1 would focus on creating a compliance structure that is transparent and minimizes conflicts. Section 3C(j) of the Exchange Act provides flexibility in permitting the CCO to report either to the clearing agency's board or to a senior officer. Because the

Commission is concerned that a clearing agency's commercial interests might discourage a clearing agency's CCO from making forthright disclosure about compliance failures of the clearing agency, the proposed rule would insulate the CCO from management pressures by preventing a senior officer of a clearing agency from removing the CCO or determining the CCO's compensation without the approval of a majority of the clearing agency's board. This would provide the benefit of aligning the CCO's position within the clearing agency with having the CCO serve as a mechanism that freely encourages compliance.

The reliability of clearance and settlement services depends on the integrity of a clearing agency's operations. As a result of the proposed rule, the accuracy, reliability, and integrity of the clearing agency would be less likely to be harmed by violations of the securities laws because experience has shown that strong internal compliance programs lower the likelihood of securities laws violations and enhance the likelihood that any violations that do occur will be detected and corrected. The designation of a CCO, who will, among other things, monitor the clearing agency's compliance with the Exchange Act (including Section 17A) and the rules and regulations thereunder and with the relevant clearing agency policies and procedures, will help ensure that each clearing agency complies with the written policies and procedures it adopts.

2. Costs

As discussed in section V.D.6., the Commission preliminarily believes that there are analogous policies and procedures requirements for Regulation NMS and in the proposed requirements for security-based swap data repositories that are informative of the burdens and related costs for clearing agencies under proposed Rule 3Cj-1.

The establishment of a designated CCO and compliance with the accompanying responsibilities of a CCO would impose certain costs on each clearing agency. The Commission estimates that the average initial costs associated with establishing policies and procedures for the remediation of non-compliance issues identified by the CCO and establishing and following appropriate procedures for the handling, management response, remediation, retesting, and closing of non-compliance issues would require approximately 420 hours of employee time and approximately $40,000 for each clearing agency, and the average ongoing paperwork cost would be 120 hours for each clearing agency. In addition, each clearing agency would be required to hire a CCO to comply with the proposed rules, at an annual cost of approximately $761,400 for each clearing agency.[304] Therefore, the aggregate initial estimated dollar cost per year to each clearing agency would be approximately $191,654 for each respondent clearing agency, corresponding to an aggregate initial estimated cost to all respondent clearing agencies of approximately $3,258,118[305] and the aggregate ongoing estimated dollar cost per year would be approximately $13,596,600[306] to comply with the proposed rule.

The Commission estimates that the average ongoing paperwork cost associated with preparing, signing and submitting annual compliance reports pursuant to proposed Rule 3Cj-1(c)(iii) and (iv) would be 54 hours for each respondent clearing agency, corresponding to an

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304 This figure was calculated as follows: Chief Compliance Officer for 1,800 hours at $423 per hour = $761,400. See supra note 279 regarding hourly rates for professionals taken from SIFMA's Management & Professional Earnings in the Securities Industry 2010, and modified by the Commission's staff.

305 This figure was calculated as follows: ((Assistant General Counsel for 87 hours at $430 per hour) + (Compliance Attorney for 77 hours at $320 per hour) + (Computer Operations Department Manager for 23 hours at $367 per hour) + (Senior Business Analyst for 23 hours at $232 per hour)) = $75,827 x 2 policies and procedures + $40,000 in one-time outside legal costs = $191,654 x 17 respondent clearing agencies = $3,258,118. See supra notes 275 and 277.

306 This figure was calculated as follows: Compliance Attorney for 60 hours at $320 per hour = $19,200 x 2 policies and procedures = $38,400 + $761,400 for the annual salary of a Chief Compliance Officer = $799,800 x 17 respondent clearing agencies = $13,596,600. See supra notes 276 and 304.

annual cost of $17,036 for each clearing agency and an aggregate annual cost of $289,612 for all respondent clearing agencies.[307]

The Commission believes that currently-existing clearing agencies already maintain compliance programs that are overseen by a CCO or an individual who effectively serves as a CCO. In addition, such clearing agencies may prepare compliance reports presented to senior management and/or the clearing agency's board and board committees as part of their current business practice. Therefore, the Commission expects that clearing agencies with substantial commitments to compliance would probably incur only minimal costs in connection with the adoption of the proposed rule. However, for a clearing agency that does not already prepare these types of annual compliance reports as part of its compliance program, the requirements under proposed Rule 3Cj-1 would likely require the labor of clearing agency staff and impose direct costs on the clearing agency as described above.

E. Request for Comment

The Commission solicits comments on the benefits and costs related to proposed Rules 17Ad-22, 17Ad-23, 17Ad-24, 17Ad-25, 17Ad-26, 17Ab2-1, 3Cj-1 and 17j-1. The Commission specifically requests comments on the initial and ongoing costs associated with these rules and the costs associated with any personnel that may be necessary to support compliance with the rules. Are there additional costs that the Commission should consider? Are there alternatives that the Commission should consider? Do the estimates accurately reflect the costs that are discussed? Please describe and, to the extent practicable, quantify the costs associated with any comments that are submitted.

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307 This figure was calculated as follows: ((Compliance Attorney for 50 hours at $320 per hour) + (Senior Systems Analyst for 4 hours at $259 per hour)) = $17,036 x 17 respondent clearing agencies = $289,612. <u>See</u> <u>supra</u> note 278.

The Commission requests data to quantify the costs and the value of the benefits discussed above. The Commission seeks estimates of these costs and benefits, as well as any costs and benefits not addressed, which may result from the adoption of the proposed rules. Commenters should provide analysis and empirical data to support their views.

VII. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

Section 23(a) of the Exchange Act[308] requires the Commission, when making rules and regulations under the Exchange Act, to consider the effect a new rule would have on competition. Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.[309] Section 3(f) of the Exchange Act[310] requires the Commission, when engaging in rulemaking that requires it to consider whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action would promote efficiency, competition, and capital formation.

The economic effects of the proposed rules were discussed in detail in the costs and benefits section.[311] These effects encompassed effects on economic efficiency, competition, and capital formation.

To reiterate, proposed Rules 17Ad-22 through 17Ad-26, 17Aj-1, 3Cj-1 and the proposed amendments to Rule 17Ab2-1 would set standards for the operation and governance of registered clearing agencies. These proposed rules are intended to further the purposes of the Exchange

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308 15 U.S.C. 78w(a).

309 15 U.S.C. 78w(a)(2).

310 15 U.S.C. 78c(f).

311 <u>See</u> discussion <u>supra</u> at Section VI. Consideration of Costs and Benefits and accompanying subsections A. through E.

Act and to promote transparency and accountability consistent with the stated goals of the Dodd-Frank Act.[312]

Evidence from the securities markets suggests that clearing agencies over the long-run tend to converge to a small number of entities or even a single entity. In part, the Commission preliminarily believes that this is because clearing activities are characterized by high start-up costs and low marginal costs so that there are large economies of scale. For example, currently all trades executed on the eight U.S. based options exchanges are cleared at The Options Clearing Corporation, and trades executed on the U.S. equity markets, composed of exchanges, alternative trading platforms, and OTC trading, are cleared at National Securities Clearing Corporation. In this same way, it is possible that a single security-based swap clearing agency may prove itself through market forces to be the most-efficient mechanism to serve all security-based swap clearing participants by delivering the lowest-cost services.

As noted above, the current market structure for clearing agencies includes four registered clearing agencies and four entities operating pursuant to the CDS Clearing Exemption Orders that are eligible to become registered security-based swap clearing agencies pursuant to the Deemed Registered Provision of the Dodd-Frank Act. In addition, the Commission preliminarily believes there may be entities using instrumentalities of interstate commerce to perform collateral management, trade matching, Tear Up Services or similar security-based swap lifecycle event services that consequently may trigger the clearing agency registration requirement.[313]

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312 See supra note 2 and accompanying text.

313 See supra note 101 and accompanying text (noting that this list of services that may trigger clearing agency registration is not exhaustive and urging every security-based swap lifecycle event service provider to consider whether their function places them within the clearing agency definition).

The intent of the proposed rules concerning standards for clearing agency operations and governance standards of clearing agencies is to promote the prompt and accurate clearance and settlement of securities transactions, including security-based swap transactions, by requiring certain minimum standards at clearing agencies. The Commission preliminarily believes that these requirements would ensure resilient and cost-effective clearing agency operations as well as promote transparent and effective clearing agency governance that would consequently support confidence among market participants in clearing agencies' ability to serve as efficient mechanisms for clearance and settlement and to facilitate capital formation.

Additionally, the Commission believes that proposed Rule 17Aj-1 would support efficiency and the capital formation process by promoting security-based swap price transparency so that market participants have access to more information to value their security-based swap positions. Under the Dodd-Frank Act, all security-based swap transactions are required to be reported to a security-based swap data repository, or, if no such data repository exists, to the Commission.[314] Consequently, security-based swap data repositories consolidate post-trade information about security-based swaps. The Commission preliminarily believes this is helpful for analyzing the security-based swap market as a whole and identifying its risks.[315] Similarly, security-based swap execution facilities provide important pre-trade information about

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314 See Pub. L. No. 111-203, §§ 763(i) and 766(a) (adding Exchange Act Sections 13(m)(1)(G) and 13A(A)(1), respectively). The Dodd-Frank Act amends the CEA to provide for a similar regulatory framework with respect to transactions in swaps regulated by the CFTC.

315 See Exchange Act Release No. 63347 (November 19, 2010), 75 FR 77306 (December 10, 2010) (discussing in Section II, Role, Regulation, and Business Models of SDRs, that the enhanced transparency provided by an SDR is important to help regulators and others monitor the build-up and concentration of risk exposures in the security-based swap market).

security-based swaps. In addition, there are also financial services information firms that provide certain security-based swap pricing data.

However, the Commission preliminarily believes that the pricing and valuation information generated by security-based swap clearing agencies adds value beyond these pre- and post-trade pricing sources as well as information that may be available from firms that provide financial services data. This is because proposed Rule 17Aj-1 would require a security-based swap clearing agency that performs CCP services to produce end-of-day settlement prices for all security-based swaps that it clears. This end-of-day pricing information represents pricing during the life of a security-based swap that is unique because it is not available from pre- and post-trade sources.

The Commission also preliminarily believes that this information is distinct from pricing information made available by firms that sell certain security-based swap pricing date, because each clearing agency's prices are generated daily while pricing information available through other sources may rely on various methods to derive a price — for instance an average of the bid and ask for a particular security-based swap or an executed trade price that would otherwise be stale but that has been adjusted through certain modeling practices to estimate a current price. Therefore, the Commission preliminarily believes that the public availability of these end-of-day settlement prices, as well as any other pricing information the security-based swap clearing agency publishes or distributes with respect to security-based swaps can provide helpful transparency to market participants about the current value of their security-based swap positions. Accordingly, the Commission preliminarily believes that requiring this information to be made publicly available on terms that are fair, reasonable and not unreasonably discriminatory improves fairness, efficiency, and market competition by providing availability to pricing information that may otherwise be difficult for some market participants to obtain and that, among other benefits, would allow those market participants to be better-informed about the fair value of their security-based swap positions and to try to more efficiently manage the utility of those positions within their portfolio.

The Commission requests comment on the possible effects of proposed Rules 17Ad-22, 17Ad-23, 17Ad-24, 17Ad-25, 17Ad-26, 17Aj-1, 3Cj-1 and the amendments to Rule 17Ab2-1 on efficiency, competition, and capital formation. The Commission requests that commenters provide views and supporting information regarding any such effects. The Commission recognizes that such effects may be difficult to quantify. The Commission seeks comment on possible anti-competitive effects of the proposed rules not already identified. The Commission also requests comments regarding the competitive effects of pursuing alternative regulatory approaches that are consistent with Sections 763 and 805 of the Dodd-Frank Act and Section 17A of the Exchange Act. In addition, the Commission requests comment on how the other provisions of the Dodd-Frank Act for which Commission rulemaking is required will interact with and influence the competitive effects of the proposed rules under proposed Rules 17Ad-22 through 17Ad-26, 17Aj-1, 3Cj-1 and the amendments to Rule 17Ab2-1.

VIII. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 ("SBREFA")[316], the Commission must advise the OMB as to whether the proposed rule constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in: (i) an annual effect on the economy of $100 million or more (either in the form of an increase or a decrease); (ii) a major increase in costs or prices for

[316] Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

consumers or individual industries; or (iii) significant adverse effect on competition, investment or innovation. If a rule is "major," its effectiveness will generally be delayed for sixty days pending Congressional review.

The Commission requests comment on the potential impact of proposed Rules 17Ad-22 through 17Ad-26, 17Aj-1, 3Cj-1 and the amendments to Rule 17Ab2-1 on the economy on an annual basis, any potential increase in costs or prices for consumers or individual industries, and any potential effect on competition, investment or innovation. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

IX. Regulatory Flexibility Act Certification

The Regulatory Flexibility Act ("RFA")[317] requires the Commission, in promulgating rules, to consider the impact of those rules on small entities. Section 603(a) [318] of the Administrative Procedure Act,[319] as amended by the RFA, generally requires the Commission to undertake a regulatory flexibility analysis of all proposed rules to determine the impact of such rulemaking on "small entities."[320] Section 605(b) of the RFA states that this requirement shall not apply to any proposed rule which, if adopted, would not have a significant economic impact on a substantial number of small entities.[321]

A. Registered Clearing Agencies

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[317] 5 U.S.C. 601 et seq.

[318] 5 U.S.C. 603(a).

[319] 5 U.S.C. 551 et seq.

[320] Section 601(b) of the RFA permits agencies to formulate their own definitions of "small entities." The Commission has adopted definitions for the term "small entity" for the purposes of rulemaking in accordance with the RFA. These definitions, as relevant to this proposed rulemaking, are set forth in Rule 0-10, 17 CFR 240.0-10.

[321] See 5 U.S.C. 605(b).

Proposed Rules 17Ad-22 through 17Ad-26, 17Aj-1, 3Cj-1 and amended Rule 17Ab2-1 would apply to all registered clearing agencies and set standards for the operation and governance of such clearing agencies. For the purposes of Commission rulemaking and as applicable to proposed Rules 17Ad-22 through 17Ad-26, 17Aj-1, 3Cj-1 and amended Rule 17Ab2-1, a small entity includes, when used with reference to a clearing agency, a clearing agency that (i) compared, cleared and settled less than $500 million in securities transactions during the preceding fiscal year, (ii) had less than $200 million of funds and securities in its custody or control at all times during the preceding fiscal year (or at any time that it has been in business, if shorter) and (iii) is not affiliated with any person (other than a natural person) that is not a small business or small organization.[322] Under the standards adopted by the Small Business Administration, small entities in the finance industry include the following: (i) for entities engaged in investment banking, securities dealing and securities brokerage activities, entities with $6.5 million or less in annual receipts; (ii) for entities engaged in trust, fiduciary and custody activities, entities with $6.5 million or less in annual receipts; and (iii) funds, trusts and other financial vehicles with $6.5 million or less in annual receipts.[323]

Based on the Commission's existing information about the clearing agencies currently registered with the Commission and the four entities clearing security-based swaps pursuant to the CDS Clearing Exemption Orders,[324] the Commission preliminarily believes that such entities exceed the thresholds defining "small entities" set out above. While other clearing agencies may emerge and become eligible to operate as clearing agencies and while other security-based swap

322 17 CFR 240.0-10(d).

323 13 CFR 121.201, Sector 52.

324 As of July 21, 2010, the following four clearing agencies are eligible to clear security-based swaps as a result of having been granted temporary exemptive orders to operate as clearing agencies for CDS: CME, Eurex, ICE Trust and ICE Clear Europe.

lifecycle event service providers may be required to register as clearing agencies, the Commission preliminarily does not believe that any such entities would be "small entities" as defined in Exchange Act Rule 0-10.[325] Furthermore, we believe it is unlikely that any clearing agencies, security-based swap clearing agencies or security-based swap lifecycle event services providers would have annual receipts of less than $6.5 million. Accordingly, the Commission believes that any registered clearing agencies will exceed the thresholds for "small entities" set forth in Exchange Act Rule 0-12.

B. Certification

In the Commission's preliminary view, proposed Rules 17Ad-22 through 17Ad-26, 17Aj-1, 3Cj-1 and amended Rule 17Ab2-1 would not have a significant economic impact on a substantial number of small entities for the purposes of the RFA. For the reasons described above, the Commission certifies that the proposed rules would not have a significant economic impact on a substantial number of small entities. The Commission requests comment regarding this certification. The Commission requests that commenters describe the nature of any impact on small entities, including clearing agencies, other counterparties to security-based swap transactions and security-based swap lifecycle event service providers, and provide empirical data to support the extent of the impact.

X. Statutory Basis and Proposed Rule Text

Pursuant to the Exchange Act, particularly, Sections 17A(d) thereof, 15 U.S.C. 78q-1(d), Sections 17A(i), 17A(j) and 3C(j) thereof, Pub. L. 111-203, §763, 124 Stat. 1841 (2010), and Sections 30(b) and 30(c) thereof, 15 U.S.C. 78dd(b)and (c), and Section 805(a)(2) of the

325 See 17 CFR 240.0-10(d). The Commission based this determination on its review of public sources of financial information about existing CCPs serving the OTC derivatives market and lifecycle event service providers.

Clearing Supervision Act, 12 U.S.C. 5464(a)(2), the Commission proposes: (1) new Rules 17Ad-22(a), 17Ad-22(d), 17Ad-23, 17Ad-24, 17Ad-25, 17Ad-26 and 3Cj-1, which would govern clearing agencies; (2) new Rules 17Ad-22(b) and (c), which would govern clearing agencies that perform central counterparty services; (3) new Rule 17Aj-1, which would govern security-based swap clearing agencies that provide central counterparty services; and (4) to amend Rule 17Ab2-1.

List of Subjects in 17 CFR Parts 240 and 249

Reporting and recordkeeping requirements, Securities.

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE

1. The authority citation for Part 240 is amended by adding the following citation in numerical order to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78o-4, 78p, 78q, 78q-1, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et. seq.; 18 U.S.C. 1350; and 12 U.S.C. 5221(e)(3), unless otherwise noted.

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Section 240.3Cj-1 is also issued under Pub. L. 111-203, §763, 124 Stat. 1841 (2010).

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Sections 240.17Ad-22 through 240.17Ad-26 are also issued under 12 U.S.C. 5464(a)(2).

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2. Section 240.17Ad-22 is added to read as follows:

§240.17Ad-22 Standards for clearing agencies.

(a) Definitions.

(1) Central counterparty means a clearing agency that interposes itself between the counterparties to securities transactions, acting functionally as the buyer to every seller and the seller to every buyer.

(2) Central securities depository services means services of a clearing agency that is a securities depository as described in section 3(a)(23) of the Act.

(3) Participant as used in paragraphs (b)(3) and (d)(14) means that if a participant controls another participant or is under common control with another participant then the affiliated participants shall be collectively deemed to be a single participant for purposes of that subparagraph.

(4) Normal market conditions as used in paragraphs (b)(1) and (2) means conditions in which the expected movement of the price of cleared securities would produce changes in a clearing agency's exposures to its participants that would be expected to breach margin requirements or other risk control mechanisms only one percent of the time.

(5) Net capital as used in paragraphs (b)(7) means net capital as defined in Rule 15c3-1 under the Act for broker-dealers or any similar risk adjusted capital calculation for all other prospective clearing members.

(b) A clearing agency that performs central counterparty services shall establish, implement, maintain and enforce written policies and procedures reasonably designed to:

(1) Measure its credit exposures to its participants at least once a day and limit its exposures to potential losses from defaults by its participants in normal market conditions so that the operations of the clearing agency would not be disrupted and non-defaulting participants

would not be exposed to losses that they cannot anticipate or control.

(2) Use margin requirements to limit its credit exposures to participants in normal market conditions and use risk-based models and parameters to set margin requirements and review them at least monthly.

(3) Maintain sufficient financial resources to withstand, at a minimum, a default by the participant to which it has the largest exposure in extreme but plausible market conditions; provided that a security-based swap clearing agency shall maintain sufficient financial resources to withstand, at a minimum, a default by the two participants to which it has the largest exposures in extreme but plausible market conditions.

(4) Provide for an annual model validation consisting of evaluating the performance of the clearing agency's margin models and the related parameters and assumptions associated with such models by a qualified person who does not perform functions associated with the clearing agency's margin models (except as part of the annual model validation) and does not report to a person who performs these functions.

(5) Provide the opportunity for a person that does not perform any dealer or security-based swap dealer services to obtain membership at the clearing agency to clear securities for itself or on behalf of other persons.

(6) Have membership standards that do not require that participants maintain a portfolio of any minimum size or that participants maintain a minimum transaction volume.

(7) Provide a person that maintains net capital equal to or greater than $50 million with the ability to obtain membership at the clearing agency, with any net capital requirements being scalable so that they are proportional to the risks posed by the participant's activities to the clearing agency; provided, however, that the clearing agency may provide for a higher net capital

requirement as a condition for membership at the clearing agency if the clearing agency demonstrates to the Commission that such a requirement is necessary to mitigate risks that could not otherwise be effectively managed by other measures and the Commission approves the higher net capital requirement as part of a rule filing or clearing agency registration application.

(c) Record of financial resources and annual audited financial report.

(1) Each fiscal quarter (based on calculations made as of the last business day of the clearing agency's fiscal quarter), or at any time upon Commission request, a clearing agency that performs central counterparty services shall calculate and maintain a record, in accordance with § 240.17a-1 of this chapter, of the financial resources necessary to meet the requirements of paragraph (b)(3) of this rule and sufficient documentation to explain the methodology it uses to compute such financial resource requirement.

(2) Each clearing agency shall post on its website an annual audited financial report. Each financial report shall:

(i) Be a complete set of financial statements of the clearing agency for the most recent two fiscal years of the clearing agency and be prepared in accordance with U.S. generally accepted accounting principles, except that for a clearing agency that is a corporation or other organization incorporated or organized under the laws of any foreign country the financial statements may be prepared in accordance with U.S. generally accepted accounting principles or International Financial Reporting Standards as issued by the International Accounting Standards Board;

(ii) Be audited in accordance with standards of the Public Company Accounting Oversight Board by a registered public accounting firm that is qualified and independent in accordance with Rule 2-01 of Regulation S-X (17 CFR 210.2-01); and

(iii) Include a report of the registered public accounting firm that complies with paragraphs (a) through (d) of Rule 2-02 of Regulation S-X (17 CFR 210.2-02).

(d) Each clearing agency shall establish, implement, maintain and enforce written policies and procedures reasonably designed to, as applicable:

(1) Provide for a well founded, transparent, and enforceable legal framework for each aspect of its activities in all relevant jurisdictions.

(2) Require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the clearing agency; have procedures in place to monitor that participation requirements are met on an ongoing basis; and have participation requirements that are objective, publicly disclosed, and permit fair and open access.

(3) Hold assets in a manner whereby risk of loss or of delay in its access to them is minimized; and invest assets in instruments with minimal credit, market and liquidity risks.

(4) Identify sources of operational risk and minimize them through the development of appropriate systems, controls, and procedures; implement systems that are reliable, resilient and secure, and have adequate, scalable capacity; and have business continuity plans that allow for timely recovery of operations and fulfillment of a clearing agency's obligations.

(5) Employ money settlement arrangements that eliminate or strictly limit the clearing agency's settlement bank risks, that is, its credit and liquidity risks from the use of banks to effect money settlements with its participants; and require funds transfers to the clearing agency to be final when effected.

(6) Be cost-effective in meeting the requirements of participants while maintaining safe and secure operations.

(7) Evaluate the potential sources of risks that can arise when the clearing agency

establishes links either cross-border or domestically to clear trades, and ensure that the risks are managed prudently on an ongoing basis.

(8) Have governance arrangements that are clear and transparent to fulfill the public interest requirements in section 17A of the Act applicable to clearing agencies, to support the objectives of owners and participants, and to promote the effectiveness of the clearing agency's risk management procedures.

(9) Provide market participants with sufficient information for them to identify and evaluate the risks and costs associated with using its services.

(10) Immobilize or dematerialize securities certificates and transfer them by book entry to the greatest extent possible when the clearing agency provides central securities depository services.

(11) Make key aspects of the clearing agency's default procedures publicly available and establish default procedures that ensure that the clearing agency can take timely action to contain losses and liquidity pressures and to continue meeting its obligations in the event of a participant default.

(12) Ensure that final settlement occurs no later than the end of the settlement day; and require that intraday or real-time finality be provided where necessary to reduce risks.

(13) Eliminate principal risk by linking securities transfers to funds transfers in a way that achieves delivery versus payment.

(14) Institute risk controls, including collateral requirements and limits to cover the clearing agency's credit exposure to each participant exposure fully, that ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle when the clearing agency provides central securities depository services and extends intraday

credit to participants.

(15) State to its participants the clearing agency's obligations with respect to physical deliveries and identify and manage the risks from these obligations.

3. Section 240.17Aj-1 is added to read as follows:

§240.17Aj-1 Dissemination of pricing and valuation information by security-based swap clearing agencies that perform services as a central counterparty.

Each security-based swap clearing agency that performs services as a central counterparty shall make available to the public, on terms that are fair and reasonable and not unreasonably discriminatory, all end-of-day settlement prices and any other prices with respect to security-based swaps that the clearing agency may establish to calculate mark-to-market margin requirements for its participants and any other pricing or valuation information with respect to security-based swaps as is published or distributed by the clearing agency to is participants.

4. Section 240.17Ad-23 is added to read as follows:

§240.17Ad-23 Clearing agency policies and procedures to protect the confidentiality of trading information of clearing agency participants.

Each clearing agency shall establish, implement, maintain, and enforce written policies and procedures reasonably designed to protect the confidentiality of any and all transaction information that the clearing agency receives. Such policies and procedures shall include, but are not limited to, (a) limiting access to confidential trading information of clearing members to those employees of the clearing agency who are operating the system or responsible for its compliance with any other applicable laws or rules and (b) standards controlling employees and agents of the clearing agency trading for their personal benefit or the benefit of others.

5. Section 240.17Ad-24 is added to read as follows:

§240. 17Ad-24 Exemption from clearing agency definition for certain registered securities based swap dealers and registered security-based swap execution facilities.

A registered security-based swap dealer and a registered security-based swap execution facility shall be exempt from inclusion in the term clearing agency, as defined in section 3(a)(23)(A) of the Act, where such registered security-based swap dealer or registered security-based swap execution facility would be deemed to be a clearing agency solely by reason of functions performed by such institution as part of customary dealing activities or providing facilities for comparison of data respecting the terms of settlement of securities transactions effected on such registered security-based swap execution facility, respectively, or solely by reason of acting on behalf of a clearing agency or participant therein in connection with the furnishing by the clearing agency of services to its participants or the use of services of the clearing agency by its participants.

6. Section 240.17Ab2-1 Registration of clearing agencies is amended by revising paragraphs (c)(1) and (c)(2) to read as follows:

§240.17Ab2-1 Registration of clearing agencies.

(c)(1) The Commission, upon the request of a clearing agency or upon the election of the Commission, may grant registration of the clearing agency in accordance with sections 17A(b) and 19(a)(1) of the Act for a specific period of time and may exempt, other than for purposes of section 17A(g) of the Act, the registrant from one or more of the requirements as to which the Commission is directed to make a determination pursuant to paragraphs (A) through (I) of section 17A(b)(3) of the Act, provided that any such registration shall be effective only for twenty-four months from the date the registration is made effective (or such longer period as the Commission may provide by order).

(2) In the case of any clearing agency registered in accordance with paragraph (c)(1) of this section, not later than fifteen months from the date such registration is made effective (or such longer period as the Commission may provide by order) the Commission either will grant registration in accordance with sections 17A(b) and 19(a)(1) of the Act, without, as applicable, exempting the registrant from one or more of the requirements as to which the Commission is directed to make a determination pursuant to subparagraphs (A) through (I) of section 17A(b)(3) of the Act or without limiting the duration of the registration, or will institute proceedings in accordance with section 19(a)(1)(B) of the Act to determine whether registration should be denied at the expiration of the registration granted in accordance with paragraph (c)(1) of this section.

7. Section 240.17Ad-25 is added to read as follows:

§240.17Ad-25 Clearing agency procedures to identify and address conflicts of interest.

Each clearing agency shall establish, implement, maintain and enforce written policies and procedures reasonably designed to identify and address existing or potential conflicts of interest. Such policies and procedures must also be reasonably designed to minimize conflicts of interest in decision making by the clearing agency.

8. Section 240.17Ad-26 is added to read as follows:

§240.17Ad-26 Standards for board or board committee members.

(a) Each clearing agency shall establish governance standards for its board members and board committee members.

(b) Such standards shall address at least the following areas:

(1) A clear articulation of the roles and responsibilities of directors serving on the clearing agency's board and any board committees;

(2) Director qualifications providing criteria for expertise in the securities industry, clearance and settlement of securities transactions, and financial risk management;

(3) Disqualifying factors concerning serious legal misconduct, including violations of the federal securities laws; and

(4) Policies and procedures for the periodic review by the board or a board committee of the performance of its individual members.

9. Section 240.3Cj-1 is added to read as follows:

§240.3Cj-1 Designation of chief compliance officer.

(a) In general. Each clearing agency shall designate a chief compliance officer. The compensation and removal of the chief compliance officer shall require the approval of a majority of the clearing agency's board.

(b) Duties. The chief compliance officer shall:

(1) Report directly to the board of directors or to the senior officer of the clearing agency;

(2) In consultation with its board, a body performing a function similar thereto, or the senior officer of the registered clearing agency, resolve any conflicts of interest that may arise;

(3) Be responsible for administering each policy and procedure that is required to be established pursuant to section 3C of the Act (15 U.S.C. 78c-3) and the rules and regulations thereunder;

(4) Ensure compliance with the Act and the rules and regulations thereunder;

(5) Establish policies and procedures for the prompt remediation of any non-compliance issues identified by the chief compliance officer; and

(6) Establish and follow appropriate procedures for the prompt handling, management response, remediation, retesting, and closing of non-compliance issues.

(c) Annual Reports.

(1) In general. The chief compliance officer shall annually prepare and sign a report that contains a description of:

(i) The compliance of the clearing agency with respect to the federal securities laws and the rules and regulations thereunder; and

(ii) Each policy and procedure of the clearing agency of the compliance officer (including the code of ethics and conflict of interest policies of the registered clearing agency).

(2) Requirements. An annual compliance report under this section shall:

(i) Accompany each appropriate financial report of the clearing agency that is required to be furnished to the Commission pursuant to the Act and the rules thereunder;

(ii) Include a certification that, under penalty of law, the compliance report is accurate and complete;

(iii) Be submitted to the board of directors and audit committee (or equivalent bodies) of the clearing agency promptly after the date of execution of the required certification and prior to filing of the report with the Commission; and

(iv) Be filed with the Commission in a tagged data format in accordance with the instructions contained in the EDGAR Filer Manual, as described in Rule 301 of Regulation S-T (17 CFR 232.301).

(v) Be filed with the Commission within 60 days after the end of the fiscal year covered by such report.

(e) For purposes of this rule, references to senior officer shall include the chief executive officer, or other equivalent officer.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Date: March 3, 2011

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 242

[Release No. 34-64018; File No. S7-27-10]

RIN 3235-AK74

Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps under Regulation MC

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule; reopening of comment period.

SUMMARY: The Securities and Exchange Commission ("Commission") is reopening the period for public comment on proposed Regulation MC under the Securities Exchange Act of 1934 ("Exchange Act"), which is designed to mitigate potential conflicts of interest at clearing agencies that clear security-based swaps ("security-based swap clearing agencies"), security-based swap execution facilities ("SB SEFs"), and national securities exchanges that post or make available for trading security-based swaps ("SBS exchanges"). The proposal was originally published in Securities Exchange Act Release No. 63107 (October 14, 2010), 75 FR 65882 (October 26, 2010) ("Regulation MC Proposing Release"). The Commission is reopening the period for public comment to solicit further comment on Regulation MC in light of other more recent proposed rulemakings that concern conflicts of interest at security-based swap clearing agencies and SB SEFs.

DATES: Comments should be received on or before April 29, 2011.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File No. S7-27-10 on the subject line; or
- Use the Federal eRulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File No. S7-27-10. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/proposed.shtml). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, N.E., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Proposals relating to security-based swap clearing agencies: Catherine Moore, Senior Special Counsel, at (202) 551-5710; and Joseph P. Kamnik, Special Counsel, at (202) 551-5710, Office of Clearance and Settlement, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-7010; proposals relating to SB SEFs and SBS exchanges: Nancy J. Burke-Sanow, Assistant Director, at (202) 551-5620; Susie Cho, Special Counsel, at (202) 551-5639; Sarah Schandler, Special Counsel, at (202) 551-7145; Iliana Lundblad, Attorney-Advisor, at (202) 551-5871; and Jasmin Sethi, Attorney-Advisor, at (202) 551-5781, Office of Market Supervision, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-7010.

SUPPLEMENTARY INFORMATION:

I. Introduction

The Commission proposed Regulation MC pursuant to Section 765 of the Dodd Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") to mitigate conflicts of interest with respect to security-based swap clearing agencies, SB SEFs, and SBS exchanges.[1] Section 765(a) of the Dodd-Frank Act provides that the Commission shall adopt rules, which may include numerical limits on the control of, or the voting rights with respect to, any security-based swap clearing agency, or on the control of any SB SEF or SBS exchange, by certain specified entities.[2] Under Section 765(b) of the Dodd-Frank Act, the Commission shall adopt such rules if it determines that they are necessary or appropriate to improve the governance of, or to mitigate systemic risk, promote competition or mitigate conflicts of interest in connection with a security-based swap dealer's or major security-based swap participant's conduct of business with, a security-based swap clearing agency, SB SEF, or SBS exchange and in which such

1 The President signed the Dodd-Frank Act (Pub. L. No. 111-203, H.R. 4173) into law on July 21, 2010.

2 See Pub. L. No. 111-203, Section 765(a). The entities specified in Section 765(a) (collectively, "Specified Entities") include a bank holding company with total consolidated assets of $50 billion or more, a nonbank financial company supervised by the Board of Governors of the Federal Reserve System, an affiliate of such bank holding company or nonbank financial company, a security-based swap dealer, a major security-based swap participant, or a person associated with a security-based swap dealer or a major security-based swap participant.

security-based swap dealer or major security-based swap participant has a material debt or equity investment.[3]

In the Regulation MC Proposing Release, the Commission identified conflicts of interest that may arise when a small number of participants, including participants that are Specified Entities, exercise undue control or influence over a security-based swap clearing agency, SB SEF or SBS exchange.[4] To address these potential conflicts of interest, and pursuant to Section 765 of the Dodd-Frank Act, the Commission proposed certain restrictions in Regulation MC with respect to the ownership and voting interests in and the governance of security-based swap clearing agencies, SB SEFs and SBS exchanges. Specifically, the Commission proposed two alternative rules for security-based swap clearing agencies that would impose different degrees of voting and governance restrictions on such entities[5] and one set of rules that would impose ownership and governance limitations on SB SEFs and SBS exchanges.[6]

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3 See Pub. L. No. 111-203, Section 765(b).

4 Specifically, the Commission noted that these participants, for competitive or commercial reasons, may have an incentive to limit access by other participants to security-based swap clearing agencies, SB SEFs and SBS exchanges; to limit the scope of products cleared through security-based swap clearing agencies or traded on SB SEFs and SBS exchanges; to lower the risk management controls at security-based swap clearing agencies; and to put the commercial interests of the SB SEF or SBS exchange or the SB SEF's or SBS exchange's owners ahead of the SB SEF's or SBS exchange's market oversight responsibilities. See Regulation MC Proposing Release, 75 FR at 65884-65893.

5 Proposed Rule 701(a) of Regulation MC sets forth the "Voting Interest Focus Alternative," which would create a limitation on ownership and voting of voting interests for participants of a security-based swap clearing agency to no more than 20% on an individual basis and, in the aggregate, no more than 40% ("aggregate cap"). Proposed Rule 701(a) would also limit members' participation in the governance of the security-based swap clearing agency by requiring that at least 35% of the security-based swap clearing agency's board of directors ('board") and committees authorized to act on behalf of such board, including the risk committee, be composed of independent directors. The nominating committee of the security-based swap clearing agency's board would be required to be composed of a majority of independent directors. See Regulation MC Proposing Release, 75 FR at 65894-65899.

In the Regulation MC Proposing Release, the Commission sought commenters' views with respect to the identified conflicts of interest and its proposed rules that are designed to mitigate those conflicts. The public comment period for proposed Regulation MC closed on November 26, 2010. As of March 1, 2011, the Commission has received 100 comment letters relating to proposed Regulation MC.[7] The Commission also received 6 comment letters relating to Section 765 of the Dodd-Frank Act that were received in response to the Commission's

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Proposed Rule 701(b) of Regulation MC sets forth the "Governance Focus Alternative," which would create a limitation on ownership of voting interests for participants of a security-based swap clearing agency to no more than 5% on an individual basis but would impose no aggregate cap. Proposed Rule 701(b) would also limit members' participation in the governance of the security-based swap clearing agency by requiring that at least a majority of the security-based swap clearing agency's board and committees authorized to act for such board, including the risk committee, be composed of independent directors. The nominating committee of the security-based swap clearing agency's board would be required to be composed solely of independent directors. See Regulation MC Proposing Release, 75 FR at 65899-65903.

6 Proposed Rule 702(b) of Regulation MC would impose a 20% limitation on ownership and voting of voting interests in a SB SEF or an SBS exchange by each participant of a SB SEF or member of an SBS exchange. Proposed Rules 702(d) and (g) would require that the board of a SB SEF or SBS exchange, any executive committee of such board, and any board committee with the authority to act on behalf of the board, be composed of a majority of independent directors, and proposed Rule 702(f) would require the nominating committee of the board of the SB SEF or SBS exchange to be composed solely of independent directors. Proposed Rule 702(e) would require the board of the SB SEF or SBS exchange to establish a regulatory oversight committee consisting solely of independent directors to oversee the SB SEF's or SBS exchange's regulatory program. Any recommendation of the regulatory oversight committee not adopted by the board of the SB SEF or SBS exchange would be required to be reported promptly to the Commission. Further, proposed Rule 702(h) would require the disciplinary processes of the SB SEF or SBS exchange to provide for compositional balance and to include at least one independent director. See Regulation MC Proposing Release, 75 FR at 65904-65912.

7 Copies of comments received in response to the Regulation MC Proposing Release are available on the Commission's Internet website, located at http://www.sec.gov/comments/s7-27-10/s72710.shtml.

general solicitation of comments regarding implementation of the Dodd-Frank Act.[8] These letters were submitted by a broad spectrum of interested parties and reflect a wide array of views regarding the proposed limitations on ownership and voting interests and governance arrangements in proposed Regulation MC.[9] A number of commenters generally supported the Commission's efforts to address conflicts of interest at security-based swap clearing agencies, SB SEFs and SBS exchanges, and many of these commenters favored imposing more restrictive ownership and voting, or governance, requirements than were proposed in Regulation MC.[10] A number of other commenters opposed some or all of the proposed restrictions and questioned whether it is necessary or appropriate for the Commission to adopt rules to mitigate conflicts of interest under Section 765 or whether the Commission should adopt rules without conducting a further review.[11]

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[8] Comments were solicited by the Commission at http://www.sec.gov/spotkight/dodd-frank/clearing-settlement.shtml. Comments in response to the Commission's general solicitation are available at http://www.sec.gov/comments/df-title-vii/mandatory-clearing/mandatory-clearing.shtml. There is no expiration to the comment period for the Commission's general solicitation.

[9] The commenters included individual investors, end-users, members of Congress, the U.S. Department of Justice, state legislators, labor organizations, potential security-based swap dealers and clearing agencies, and potential SBS exchanges or SB SEFs. See supra notes 7 and 8.

[10] See, e.g., Letter from U.S. Congressman Stephen F. Lynch, 9th District, Massachusetts (October 18, 2010); Letter from Americans for Financial Reform (November 16, 2010); Letter from Karrie McMillan, General Counsel, Investment Company Institute (November 17, 2010); Letter from Mike Hisler, Co-Founder, The Swaps & Derivatives Market Association (November 26, 2010); and Letter from Christine A. Varney, Assistant Attorney General, U.S. Department of Justice, Antitrust Division (December 28, 2010).

[11] See, e.g., Letters from Roger Liddell, Chief Executive, LCH.Clearnet Group Limited (September 24, 2010 and November 5, 2010); Letter from R. Glenn Hubbard, Co-Chair, John L. Thornton, Co-Chair, and Hal S. Scott, Director, Committee on Capital Markets Regulation (November 15, 2010); Letter from James Hill, Managing Director, Morgan Stanley (November 17, 2010); Letters from Kathleen M. Cronin, Managing Director, General Counsel and Corporate Secretary, CME Group Inc. (November 17, 2010 and

On February 2, 2011, the Commission proposed an interpretation of the definition of "security-based swap execution facility," as well as rules relating to the registration and regulation of SB SEFs.[12] The SB SEF Proposing Release includes proposals that are designed, in part, to address conflicts of interest affecting SB SEFs.[13] The SB SEF Proposing Release seeks commenters' views regarding the interaction of proposed Regulation SB SEF with proposed Regulation MC. Specifically, the SB SEF Proposing Release asks commenters, taking into account both proposals, to address whether the proposals contained in proposed Regulation SB SEF would appropriately address conflicts of interest concerns for SB SEFs or whether they should be revised either as unnecessary or insufficient to address such conflicts of interest. The SB SEF Proposing Release also asks commenters to provide their views on whether there any

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November 24, 2010); and Letter from Robert Pickel, Executive Vice Chairman, International Swaps and Derivatives Association, Inc. (November 23, 2010).

12 Securities Exchange Act Release No. 63825 (February 2, 2011), 76 FR 10948 (February 28, 2011) ("SB SEF Proposing Release").

13 Specifically, proposed Rule 809 of proposed Regulation SB SEF would require a SB SEF to permit any security-based swap dealer, major security-based swap participant or broker to become a participant of the SB SEF as long as specified objective criteria are met; proposed Rule 811(b) would require a SB SEF to establish fair, objective, and not unreasonably discriminatory standards for granting impartial access to trading on the facility, and would specify that a SB SEF may not unreasonably prohibit or limit any person with respect to access to the services offered by the SB SEF by applying those standards in an unfair or unreasonably discriminatory manner; proposed Rule 811(b) also would require information on any grants, denials or limitations of access by the SB SEF to be reported on Form SB SEF (the proposed registration form for SB SEFs) and in the required annual report of the SB SEF's Chief Compliance Officer; proposed Rule 811(c) would require a SB SEF to establish a compositionally balanced swap review committee to determine the security-based swaps that would trade on the SB SEF, as well as the security-based swaps that should no longer trade on the SB SEF; with respect to the determination regarding whether a particular security-based swap is "made available to trade," that determination would be made pursuant to objective standards to be established by the Commission; and proposed Rule 820 would require that no less than 20% of the total number of directors on the SB SEF's board be representative of SB SEF participants, and that at least one director on the SB SEF's board be representative of investors. See SB SEF Proposing Release, supra note 12.

redundancies or gaps for mitigating conflicts of interest for SB SEFs that should be addressed.[14] The public comment period for proposed Regulation SB SEF expires on April 4, 2011.

On March 2, 2011, the Commission proposed rules regarding registration of clearing agencies and standards for the operation and governance of clearing agencies[15] in accordance with Sections 763 and 805 of the Dodd-Frank Act[16] and Section 17A of the Exchange Act.[17] Some of those proposed rules are designed, in part, to address conflicts of interest affecting clearing agencies, including security-based swap clearing agencies.[18] In particular, the Clearing Agency Proposing Release includes proposed rules that would require all clearing agencies to have policies and procedures to identify and address existing or potential conflicts of interest and to establish minimum governance standards for board or board committee members.[19] In addition, the Clearing Agency Proposing Release includes proposed rules that would require clearing agencies to provide opportunity for membership access to persons that are not dealers or security-based swap dealers and persons that have net capital of at least $50 million, while also prohibiting the use of minimum portfolio size and minimum volume transaction thresholds as a

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14 See SB SEF Proposing Release, supra note 12, 76 FR at 10986.

15 Securities Exchange Act Release No. 64017 (March 2, 2011) ("Clearing Agency Proposing Release").

16 Pub. L. No. 111-203, Sections 763 and 805.

17 15 U.S.C. 78q-1.

18 Specifically, proposed Rule 17Ad-25 under the Exchange Act would require that clearing agencies have policies and procedures to identify and address existing or potential conflicts of interest and to establish minimum governance standards for board or board committee members. Proposed Rules 17Ad-22(c)(5) and (c)(7) under the Exchange Act would require clearing agencies to provide an opportunity for membership access to persons who are not dealers or security-based swap dealers and persons who have net capital of at least $50 million. In addition, Proposed Rule 17Ad-22(c)(6) under the Exchange Act would prohibit the use of minimum portfolio size and minimum volume transaction thresholds as a condition for membership. See Clearing Agency Proposing Release, supra note 15.

19 See Clearing Agency Proposing Release, supra note 15.

condition for membership, in order to decrease the potential for formal membership requirements to be applied anti-competitively.[20] The Clearing Agency Proposing Release seeks commenters' views regarding the interaction between proposed Regulation MC and the mitigation of conflicts provisions reflected in the Clearing Agency Proposing Release. The public comment period for the Clearing Agency Proposing Release closes on April 29, 2011.

When the Commission issued the SB SEF Proposing Release and Clearing Agency Proposing Release, it was mindful of its prior proposals under Regulation MC.[21] However, the Commission recognizes that commenters who provided their views and suggestions on proposed Regulation MC did not have the benefit of considering the proposals in the SB SEF Proposing Release and the Clearing Agency Proposing Release, which also seek to address some potential conflicts of interest affecting these entities, when they submitted their comments.

The Commission therefore is reopening the comment period to invite further comment on proposed Regulation MC, particularly in light of the additional proposals relating to mitigation of conflicts for security-based swap clearing agencies and SB SEFs that are contained in the Clearing Agency Proposing Release and SB SEF Proposing Release, respectively.

II. Request for Comment

Commenters are asked to consider the provisions designed to address conflicts of interest in the Regulation MC Proposing Release and in the Clearing Agency Proposing Release and the SB SEF Proposing Release, in the aggregate, when providing further comment on how the Commission should address potential conflicts of interest at security-based swap clearing

20 See Clearing Agency Proposing Release, supra note 15.

21 See SB SEF Proposing Release, supra note 12, at notes 82, 97, 127, 128, 134, 139, 141, 147, 172, 208, 269 and 570 and accompanying text, and 76 FR at 10979 and 10983-10986. See also Clearing Agency Proposing Release, supra note 15, at notes 45 and 107 and accompanying text.

agencies and SB SEFS, respectively. Are some or all of the proposed requirements in the SB SEF Proposing Release and the Clearing Agency Proposing Release and the requirements in the Regulation MC Proposing Release mutually supportive? Why or why not? Should any of the proposed requirements discussed in the SB SEF Proposing Release, the Clearing Agency Proposing Release, or the Regulation MC Proposing Release relating to conflicts of interest be revised in light of the proposed requirements relating to conflicts of interests in the other releases? If so, which requirements should be revised and how? Are the proposed requirements discussed in the SB SEF Proposing Release, the Clearing Agency Proposing Release, or the Regulation MC Proposing Release relating to conflicts of interest, when considered together, sufficient to mitigate conflicts of interest for SB SEFs, SBS exchanges or security-based swap clearing agencies, or should the Commission consider additional, or alternative, measures? Are any of the proposed requirements discussed in the SB SEF Proposing Release, the Clearing Agency Proposing Release, or the Regulation MC Proposing Release relating to conflicts of interest unnecessary in light of proposed requirements relating to conflicts of interest in the other releases? Why or why not?

Comments may provide the Commission with further insights regarding what mechanisms, if any, may be necessary or appropriate to mitigate conflicts of interest and how the proposed requirements in the three proposals should be evaluated. Commenters should provide specific reasons and information to support their views and recommendations, including an analysis of why a recommendation would satisfy the statutory mandate contained in Section 765 of the Dodd-Frank Act regarding mitigation of conflicts of interest. The Commission asks that commenters, when possible, provide the Commission with empirical data to support their views.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Date: March 3, 2011

SECURITIES AND EXCHANGE COMMISSION

17 CFR Ch. II

[Release Nos. 33-9194, 34-64021, IA-3168, IC-29593, File No. S7-09-11]

Regulatory Flexibility Agenda

AGENCY: Securities and Exchange Commission.

ACTION: Semiannual regulatory agenda.

SUMMARY: The Securities and Exchange Commission approved the publication of an agenda of its rulemaking actions pursuant to the Regulatory Flexibility Act. The agenda, which is not a part of or attached to this document, was submitted by the Commission to the Regulatory Information Service Center for inclusion in the Unified Agenda of Federal Regulatory and Deregulatory Actions, which is scheduled for publication in its entirety on www.reginfo.gov in April 2011. The version of the Unified Agenda to be published in the Federal Register will include only those rules for which the agency has indicated that preparation of an analysis under the Regulatory Flexibility Act is required. Information in the Commission's agenda was accurate on March 3, 2011, the date on which the Commission's staff completed compilation of the data. To the extent possible, rulemaking actions by the Commission after that date will be reflected in the agenda. The Commission invites questions and public comment on the agenda and on the individual agenda entries.

DATES: Comments should be received on or before June 30, 2011.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/other.shtml) or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-09-11 o

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publication of the agenda does not preclude an agency from considering or acting on any matter not included in the agenda, and that an agency is not required to consider or act on any matter that is included in the agenda (5 U.S.C. 602(d)). Actions that do not have an estimated date are placed in the long term category; the Commission may nevertheless act on items in that category within the next twelve months. The agenda includes new entries, entries carried over from previous publications, and rulemaking actions that have been completed (or withdrawn) since publication of the last agenda. The Commission invites public comment on the agenda and on the individual agenda entries.

By the Commission.

Elizabeth M. Murphy

Elizabeth M Murphy
Secretary

Dated: March 3, 2011

Commissioner Casey
Commissioner Paredes
Disapproved

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64025 / March 3, 2011

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3249 / March 3, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14283

In the Matter of S. BLAIR ABERNATHY, CPA, Respondent.	ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted against S. Blair Abernathy ("Respondent" or "Abernathy") pursuant to Rule 102(e)(3)(i) of the Commission's Rules of Practice.[1]

[1] Rule 102(e)(3)(i) provides, in relevant part, that:

The Commission, with due regard to the public interest and without preliminary hearing, may, by order, . . . suspend from appearing or practicing before it any . . . accountant . . . who has been by name . . . permanently enjoined by any court of competent jurisdiction, by reason of his or her misconduct in an action brought by the Commission, from violating or aiding and abetting the violation of any provision of the Federal securities laws or of the rules and regulations thereunder.

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Section III.3. below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. Abernathy, age 49, is a resident of La Verne, California. Abernathy was IndyMac Bancorp, Inc.'s ("IndyMac") CFO from April 25, 2008 to July 2008. Abernathy was IndyMac Bank, F.S.B.'s ("IndyMac Bank") executive vice president in charge of four Bank groups: Capital Markets (November 2007 to April 25, 2008); Specialty Lending (March 2007 to November 2007); Investment Portfolio (2004 to March 2007); and Secondary Marketing (1994 to 2004). Abernathy was licensed as a CPA in California until 2003.

2. IndyMac was a Delaware corporation with its principal executive offices in Pasadena, California. IndyMac's common stock was registered with the Commission pursuant to Section 12(b) of the Securities Exchange Act of 1934 and traded on the New York Stock Exchange until it was delisted on August 18, 2008. On July 31, 2008, IndyMac filed for Chapter 7 bankruptcy.

3. On February 11, 2011, the Commission filed a complaint against Abernathy in SEC v. Abernathy, Civil Action No. CV 11-1308-JFW (SSx), in the United States District Court for the Central District of California. On February 17, 2011, a final judgment was entered against Abernathy, permanently enjoining him from future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. §§ 77q(a)(2) & (a)(3).

4. The Commission's complaint alleged, among other things, that in 2007 Abernathy negligently made materially false and misleading statements in the offer and sale of six IndyMac Bank mortgage-backed securities offerings regarding the quality of the residential mortgage loans underlying the offerings. In addition, the Commission's complaint alleged that Abernathy negligently made false and misleading statements regarding IndyMac's capital and liquidity position in its common stock prospectus filed on May 2, 2008. The complaint alleged that Abernathy, by his conduct, violated Sections 17(a)(2) and 17(a)(3) of the Securities Act.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanction agreed to in Respondent Abernathy's Offer.

Accordingly, it is hereby ORDERED, effective immediately, that:

A. Abernathy is suspended from appearing or practicing before the Commission as an accountant.

B. After two (2) years from the date of this order, Respondent may request that the Commission consider his reinstatement by submitting an application (attention: Office of the Chief Accountant) to resume appearing or practicing before the Commission as:

1. a preparer or reviewer, or a person responsible for the preparation or review, of any public company's financial statements that are filed with the Commission. Such an application must satisfy the Commission that Respondent's work in his practice before the Commission will be reviewed either by the independent audit committee of the public company for which he works or in some other acceptable manner, as long as he practices before the Commission in this capacity; and/or

2. an independent accountant. Such an application must satisfy the Commission that:

(a) Respondent, or the public accounting firm with which he is associated, is registered with the Public Company Accounting Oversight Board ("Board") in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective;

(b) Respondent, or the registered public accounting firm with which he is associated, has been inspected by the Board and that inspection did not identify any criticisms of or potential defects in the Respondent's or the firm's quality control system that would indicate that the Respondent will not receive appropriate supervision;

(c) Respondent has resolved all disciplinary issues with the Board, and has complied with all terms and conditions of any sanctions imposed by the Board (other than reinstatement by the Commission); and

(d) Respondent acknowledges his responsibility, as long as Respondent appears or practices before the Commission as an independent accountant, to comply with all requirements of the Commission and the Board, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards.

C. The Commission will consider an application by Respondent to resume appearing or practicing before the Commission provided that his state CPA license is current and he has resolved all other disciplinary issues with the applicable state boards of accountancy. However, if state licensure is dependent on reinstatement by the Commission, the Commission will consider an application on its other merits. The Commission's review may include consideration of, in addition to the matters referenced above, any other matters relating to Respondent's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

Chairman Schapiro not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64029 / March 3, 2011

INVESTMENT ADVISERS ACT OF 1940
Release No. 3169 / March 3, 2011

INVESTMENT COMPANY ACT OF 1940
Release No. 29594 / March 3, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-13934

In the Matter of

SAM P. DOUGLASS and
ANTHONY R. MOORE,

Respondents.

ORDER MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, SECTIONS 203(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940 AS TO ANTHONY R. MOORE ("ORDER")

I.

On June 10, 2010, the Securities and Exchange Commission ("Commission") instituted public administrative and cease-and-desist proceedings pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act"), and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act") against Anthony R. Moore ("Moore" or "Respondent").

II.

Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934, Sections 203(f) and 203(k) of the Investment Advisers Act of 1940, and Section 9(b) of the Investment Company Act of 1940 as to Anthony R. Moore ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds[1] that

Summary

Sam P. Douglass, who is also a respondent in these proceedings, served as chairman of Equus Total Return, Inc. ("Equus" or "the Fund"), a business development company ("BDC"), from September 1991 through June 2005. From May 1997 through June 2005, Douglass controlled the investment adviser that provided investment advice to the Fund. During a June 2005 proxy solicitation to approve a change in Fund investment advisers, an Equus press release included a statement by Douglass that officers and directors would not receive above-market prices for their stock options in contemplated private transactions relating to the proposed adviser change. Two weeks before the press release, however, Douglass participated in negotiations with attorneys for the new adviser concerning a senior vice president's compensation package, which provided for a 26% stock-option premium.

Moore, who controlled Equus's new investment adviser, knew about the senior vice president's stock-option premium before the new adviser took over on June 30, 2005. The same day, however, he sought reimbursement of $535,000 from the Fund for "unforeseen" expenses, most of which covered the stock-option premium. Moore did not inform Equus's board or its CFO that the reimbursement request related to the premium. Equus's subsequent Commission filings, signed by Moore, contained inaccurate statements relating to the premium payment. As a result of the foregoing, Moore violated or caused violations of antifraud and other provisions of the federal securities laws.

Respondent

1. Moore, age 63, resides in London, England and is the co-founder and CEO of Moore, Clayton & Co., Inc., an international private equity investment and advisory firm. He served as Equus's co-chairman and president from June 2005 to December 2007, and as its CEO from June 2005 to August 2007.

Other Relevant Person and Entities

2. Douglass, age 78, resides in Houston, Texas and was chairman and CEO of Equus, a business development company, from September 1991 to December 2007. Douglass is an attorney licensed in Texas.

3. Equus, a Delaware corporation based in Houston, Texas, became a BDC on September 6, 1991. Equus trades as a closed-end fund on the New York Stock Exchange, under the symbol "EQS." Its securities are registered under Section 12(b) of the Exchange Act.

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[1] The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

4. Moore, Clayton & Co., Inc. ("MCC"), is an international private equity investment and advisory firm headquartered in London with operations in many countries including the United States. Moore is one of MCC's principal shareholders.

5. Moore Clayton Capital Advisors, Inc. ("MCCA"), a Delaware corporation based in Houston, Texas, is wholly owned by MCC. MCCA was a Commission-registered investment adviser from July 5, 2005 to July 6, 2009, when its contract with Equus was not renewed. MCCA became Equus's investment adviser, via proxy vote, on June 30, 2005.

6. Equus Capital Administration Company ("ECAC"), a Utah corporation based in Houston, Texas and controlled by Moore, acted as Equus's administrator from June 30, 2005 to July 1, 2009.

7. Equus Capital Management Corporation ("ECMC"), a Delaware corporation based in Houston, Texas and controlled by Douglass, was a Commission-registered investment adviser from June 8, 1984 to September 29, 2005. ECMC was Equus's investment adviser and administrator from May 9, 1997 to June 30, 2005.

Facts

Proposed Change in Equus's Investment Adviser

8. In late 2004, several large Equus shareholders pressed Equus management to consider liquidating the Fund. Consequently, on January 21, 2005, Equus's board created a special committee of three independent directors to review alternatives, including hiring a new adviser.

9. About the same time, Douglass learned that Moore wanted to purchase a U.S.-based investment management company. He proposed that Moore purchase Douglass's interest in ECMC and take over as Equus's adviser. Accordingly, in January 2005, Moore and his firm, MCC, agreed to purchase Douglass's ECMC shares. Douglass then asked the special committee to consider hiring MCCA as Equus's new investment adviser.

10. On March 31, 2005, the special committee recommended that the board engage MCCA as Equus's adviser. The special committee further recommended that ECAC (MCCA's sister company) become the Fund administrator.

11. On May 5, 2005, MCC agreed to purchase Douglass's interests in ECMC for more than $4 million. The purchase agreement was contingent on Equus shareholder and Board approval of MCCA's appointment as adviser and ECAC's appointment as administrator. As part of the agreement, MCCA agreed to purchase 27.5% of the Fund's outstanding shares.

12. Because several large Equus shareholders still favored liquidating the Fund rather than merely changing advisers, MCC agreed, as part of its purchase of Equus shares, to acquire these shareholders' stock at a negotiated price of $9.49 per share (about $1 per share above the market price).

MCCA's Proposed Advisory Agreement

13. MCCA's proposed advisory agreement with Equus provided that MCCA would receive an annual asset based fee of 2% and a performance fee equal to 20% of the Fund's realized capital gain, net of all realized capital loss and unrealized capital depreciation. This differed from Equus's agreement with ECMC, under which ECMC and its officers received stock options to incentivize their performance. Section 205 of the Advisers Act generally prohibits investment advisers from receiving performance fees. Section 205(b)(3) provides an exception for advisory contracts with BDCs if, among other things, the BDC doesn't have "outstanding any option, warrant, or right issued" pursuant to Section 61(a)(3)(B) of the Investment Company Act, which permits BDCs to issue certain options. Therefore, to enter an advisory agreement with Equus that included a performance fee, MCCA had to purchase or cancel the outstanding options issued to ECMC and Equus employees who continued to work for the Fund after the change in advisers.

The Proxy Statement

14. On April 6, 2005, Equus's board approved the special committee's recommendations and authorized the filing of proxy materials recommending that shareholders approve MCCA's advisory agreement and ECAC's administration agreement. Equus filed its preliminary proxy statement on May 10, 2005, and filed its definitive proxy statement on May 27, 2005. Both proxy filings proposed to discontinue the stock option plan and to require MCCA to purchase all outstanding stock options from the Fund's officers and directors. The proposed administration agreement stated that, while MCCA was responsible for all investment professionals' expenses including salaries, ECAC may provide "significant managerial assistance to the Fund's portfolio companies." Payments to ECAC were capped at $450,000 per year.

Retention of Certain Employees

15. After the special committee recommended MCCA as the new adviser, Moore told Douglass that MCCA needed to retain certain ECMC employees, especially its senior vice president ("the senior vice president"), an Equus senior vice president who located and evaluated the companies in which Equus invested. Thereafter, Douglass participated in negotiations with the senior vice president concerning his new compensation package.

16. On June 10, 2005, Douglass, through his assistant, sent the senior vice president an e-mail that included a summary of negotiations with MCC and its attorneys concerning the senior vice president's compensation package. That summary called for payment for the senior vice president's stock options at a price of $10.49 per share, a 26% premium over the current market price of $8.30. The premium would be paid out in a retention bonus of $60,000, with the remainder structured as a consulting agreement with ECAC that would compensate the senior vice president an additional $373,620.

Douglass's Materially Misleading Statements in a June 22, 2005 Press Release

17. On June 17, 2005, in the midst of the proxy solicitation, Dow Jones Newswire ran a story about Equus, highlighting the Fund's performance issues and discussing ongoing

disagreements between the Fund's management and certain large shareholders about the Fund's fate. The story specifically quoted one shareholder who said that the Fund "should be shut down." The Dow Jones story also noted the proxy statement's commitment that MCCA would purchase 27.5% of Equus's outstanding shares on the public market or through "privately-arranged transactions with individual shareholders." According to the story, this raised concerns among some shareholders that not all shareholders would be given the chance to sell at a favorable price.

18. In response to the Dow Jones Newswire story, Equus issued a press release on June 22, 2005, regarding the proposed change in advisers. Douglass approved the issuance of the press release, which addressed, among other things, the change in the adviser's incentive-compensation structure and MCCA's commitment to purchase shares. The press release attributed the following statement to Douglass:

> "In order to adopt the new incentive compensation structure, the Fund may not have any outstanding stock options in accordance with legal requirements. To facilitate the exercise of the existing stock options held by officers and directors, Moore Clayton may buy the shares issued upon exercise of such options. *The purchase price paid for any such shares will not exceed the current market price for the shares*." [Emphasis added.]

19. The market price for Equus shares at the time was approximately $8.30 per share. Given the agreement negotiated earlier, pursuant to which the senior vice president was to be paid a significant premium above market price for his options, the June 22, 2005 press release was materially misleading. Equus filed the press release with the Commission on June 22, 2005, under cover of Form 8-K and also filed it on June 24, 2005, as definitive additional proxy materials on Schedule 14A.

Approval of MCCA and ECAC's appointment

20. Equus's shareholders approved MCCA as the new adviser and ECAC as the new administrator on June 30, 2005. Equus's board, at a meeting later that day, approved the contracts to appoint MCCA as Equus's new adviser and ECAC as the Fund's new administrator. In addition, that day the senior vice president and Moore signed the senior vice president's consulting agreement with MCCA and his consulting agreement with ECAC.

Special Administrative Fee

21. During the June 30, 2005 board meeting, Moore disclosed that ECAC had encountered $800,000 in "unforeseen administrative expenses" relating to the adviser change and asked Equus to cover those expenses. Although not disclosed at the board meeting, a significant portion of the "unforeseen administrative expenses" was the senior vice president's compensation.

22. In response, Equus's board formed a special committee, consisting of three independent board directors, to examine the unforeseen administrative expenses and to determine whether the Fund should reimburse ECAC. During the special committee's review, an independent director discussed with Moore the components of the special administrative fee.

Moore admitted that some of the expenses included retention bonuses for the senior vice president and others, but did not enumerate the specific amounts.

23. On August 9, 2005, upon the special committee's recommendation, Equus's board agreed to pay MCCA a one-time supplemental fee of $535,000 (approximately 1% of the Fund's assets at the time) to reimburse "extraordinary costs that were incurred by the Management Company above what had been anticipated" with respect to the change in administrators. In effect, the Fund paid for the stock option premium paid to the senior vice president without any disclosure to the shareholders or the public.

24. Equus's CFO thereafter prepared (or assigned someone to prepare) a spreadsheet outlining the components of the fee: $400,000 for the senior vice president's consulting agreement with ECAC; $60,000 for the senior vice president's retention bonus; and $75,000 of retention bonuses for other personnel.

Equus's Subsequent Commission Filings

25. Equus filed its second quarter 2005 Form 10-Q on August 15, 2005. Moore certified this filing, which disclosed that the Fund had reimbursed ECAC $535,000 for unexpected costs and expenses associated with the change in administrators. The Form 10-Q, however, failed to disclose the true purposes of the special administrative fee or that the majority of the funds compensated the senior vice president.

26. On March 31, 2006, Equus filed its 2005 Form 10-K, which Moore certified. This filing also disclosed that the special administrative fee was associated with the change in administrators, but failed to disclose that the special administrative fee primarily compensated a Fund officer.

27. On April 24, 2006, Equus filed its annual proxy statement providing information about officer and director compensation in 2005. The proxy statement represented that the senior vice president received compensation of $136,620 in 2005, consisting of realized earnings from the company's acquisition of his 198,000 stock options. This figure was materially understated because the senior vice president, in fact, received more than $460,000 from the transaction. This misleading compensation disclosure was incorporated by reference in Equus's 2005 Form 10-K.

28. Moore failed to inform Equus's CFO and Equus's auditor of the premium paid to the senior vice president for his stock options. He signed management-representation letters to the auditor for the third quarter of 2005 and for fiscal year 2005 that confirmed that Equus's financial information was fairly presented and that all material transactions were properly recorded. These representations were materially misleading in light of the senior vice president's undisclosed stock-option premium.

Legal Discussion

Standards to Establish Violations

29. Section 13(a) of the Exchange Act requires issuers to file such periodic and other reports as the Commission may prescribe and in conformity with such rules as the Commission may promulgate. Exchange Act Rules 13a-1, 13a-11, and 13a-13 require the filing of annual, current, and quarterly reports, respectively. In addition to the information expressly required to be included in such reports, Rule 12b-20 of the Exchange Act requires issuers to add such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading. "The reporting provisions of the Exchange Act are clear and unequivocal, and they are satisfied only by the filing of complete, accurate, and timely reports." *SEC v. Savoy Industries*, 587 F.2d 1149, 1165 (D.C. Cir. 1978) (citing *SEC v. IMC Int'l, Inc.*, 384 F. Supp. 889, 893 (N.D. Tex. 1974)). A violation of the reporting provisions is established if a report is shown to contain materially false or misleading information. *SEC v. Kalvex, Inc.*, 425 F. Supp. 310, 316 (S.D.N.Y. 1975). No showing of *scienter* is necessary to establish an issuer's violation of Section 13(a). *SEC v. Wills*, 472 F. Supp. 1250, 1268 (D.D.C. 1978). In the securities context, *scienter* refers to a mental state embracing intent to deceive, manipulate, or defraud. *Aaron v. SEC*, 446 U.S. 680, 686 n. 5 (1980).

30. Section 13(b)(2)(A) of the Exchange Act requires issuers to "make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer." Section 13(b)(2)(B) of the Exchange Act requires issuers to devise and maintain a system of internal-accounting controls sufficient to provide reasonable assurances that transactions are recorded to permit the preparation of financial statements in conformity with generally accepted accounting principles. No showing of *scienter* is necessary to establish violations of Sections 13(b)(2)(A) and 13(b)(2)(B). *SEC v. World-Wide Coin Investments*, 567 F. Supp. 724, 749-51 (N.D. Ga. 1983).

31. Exchange Act Rule 13b2-1 prohibits a person from, directly or indirectly, falsifying or causing to be falsified any book, record, or account subject to Section 13(b)(2)(A) of the Exchange Act. Exchange Act Rule 13b2-2(a) provides that no director or officer of an issuer shall, directly or indirectly, make or cause to be made a materially false or misleading statement to an accountant or omit to state, or cause another person to omit to state, any material fact necessary in order to make statements made, in light of the circumstances under which such statements were made, not misleading, to an accountant in connection with financial-statement audits, reviews, or examinations or the preparation or filing of any document or report required to be filed with the Commission. No showing of *scienter* is required to establish a violation of Rules 13b2-1 or 13b2-2. *World-Wide Coin*, 567 F. Supp. at 749; Promotion of the Reliability of Financial Information and Prevention of the Concealment of Questionable or Illegal Corporate Payments and Practices, Exch. Act Rel. No. 15570, 16 SEC Docket 1143 (Feb. 15, 1979).

32. Exchange Act Rule 13a-14, among other things, requires a principal executive officer to certify in each quarterly and annual report filed or submitted under Section 13(a) of the Exchange Act that the officer has reviewed the report and that, based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the report.

33. Exchange Act Rule 14a-9 provides that no proxy solicitation shall be made which is materially false or misleading. A violation of this rule results in a violation of Section 14(a) of the Exchange Act. No showing of *scienter* is required. *See Wilson v. Great American Industries, Inc.*, 855 F.2d 987, 995 (2d Cir. 1988).

34. Section 206(2) of the Advisers Act prohibits an investment adviser from engaging in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client. Proof of *scienter* is not required to establish a violation of Section 206(2). *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963).

Standards for Cease-and-Desist Order, Remedial Sanctions, and Penalty

35. Under Section 21C(a) of the Exchange Act and Section 203(k) of the Advisers Act, the Commission may impose a cease-and-desist order upon any person who is violating, has violated, or is about to violate any provision of those acts and upon any other person that is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation. In this context, "cause" is based upon negligence, which is "sufficient to establish liability for causing a primary violation that does not require *scienter*." *Matter of Warwick Cap. Mgmt., Inc., et al.*, Admin. Proc. File No. 3-12357, 2007 WL 505772, at *10 (Feb. 15, 2007) (quoting *KPMG Marwick LLP*, 54 S.E.C. 1135, 1175 (2001)).

36. Under Section 203(f) of the Advisers Act, the Commission may censure, impose activities limits, suspend, or bar from association any person associated with an investment adviser who, among other things, has willfully violated any provision of the Exchange Act or Advisers Act.[2]

37. In any proceeding instituted pursuant to Section 9(b) of the Investment Company Act against any person, the Commission may impose a civil penalty if it finds that such person has willfully violated any provision of the Exchange Act.

Violations

As a result of the conduct described above, Moore willfully violated Section 14(a) of the Exchange Act and Rules 13b2-1, 13b2-2, 13a-14, and 14a-9 thereunder and caused violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-13 thereunder and Section 206(2) of the Advisers Act.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Moore's Offer.

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2 A willful violation means merely "that the person charged with the duty knows what he is doing." *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

Accordingly, pursuant Section 21C of the Exchange Act, Sections 203(f) and 203(k) of the Advisers Act, and Section 9(b) of the Investment Company Act, it is hereby ORDERED that:

A. Respondent Moore shall cease and desist from committing or causing any violations and any future violations of Section 13(a), 13(b)(2)(A), 13(b)(2)(B), and 14(a) of the Exchange Act and Rules 12b-20, 13a-1, 13a-13, 13a-14, 13b2-1, 13b2-2, and 14a-9 thereunder and Section 206(2) of the Advisers Act.

B. Respondent Moore is censured.

C. Respondent Moore shall pay a civil money penalty in the amount of $25,000 to the United States Treasury. Payment shall be made in the following installments: (1) $10,000 within 10 days of the entry of this Order; (2) $5,000 within 120 days of the entry of this Order; $5,000 within 240 days of the entry of this Order; and (3) $5,000 within 360 days of the entry of this Order. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of civil penalties, plus any additional interest accrued pursuant to 31 U.S.C. 3717, shall be due and payable immediately, without further application. Payments shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check, or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Respondent Moore as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Stephen J. Korotash, Associate Regional Director, Division of Enforcement, Securities and Exchange Commission, Burnett Plaza, Suite 1900, 801 Cherry Street, Unit 18, Fort Worth, Texas 76102.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64030 / March 3, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14285

In the Matter of

Securities Transfer Corporation and Kevin Halter, Jr.

Respondents.

ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTIONS 17A AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 17A and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Kevin Halter, Jr. ("Halter, Jr.") and Securities Transfer Corporation ("STC") (collectively "the Respondents').

II.

In anticipation of the institution of these proceedings, the Respondents have submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 17A and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondents' Offer, the Commission finds[1] that:

Summary

In this matter, Kevin Halter ("Halter"), STC's former bookkeeper and Halter, Jr.'s father, misappropriated approximately $2.7 million in agency funds entrusted to STC. From August 2007 through November 2008, Halter secretly transferred funds STC held on behalf of issuers through other STC accounts to his personal brokerage account to cover losses from his unprofitable securities trading. After a Commission examination raised questions about certain STC funds transfers, Halter confessed to Halter Jr. that Halter had taken the money. Halter Jr. immediately terminated his father's relationship with STC, demanded that his father repay the money he had misappropriated, and reported the matter to the Commission. Soon thereafter, Halter repaid the money he had taken and all affected STC clients were made whole.

Respondents

1. STC was incorporated in Texas in 1987 and has been a transfer agent registered with the Commission pursuant to Section 17A(c)(2) of the Exchange Act since 1987. STC transfers securities for approximately 600 issuers, the majority of which are quoted on the OTC Bulletin Board.

2. Halter, Jr., 49, is a resident of Frisco, Texas. He was the president and principal of STC.

Other Relevant Person

3. Kevin Halter, 75, of Desoto, Texas, served as STC's bookkeeper for approximately ten years until his termination on January 6, 2009.

Background

4. As a transfer agent, STC handles both securities and funds for its clients. It acts as a dividend paying agent for multiple issuers and also provides escrow services for specific issuer transactions.

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[1] The findings herein are made pursuant to Respondents' Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

5. From at least August 2007 until his January 2009 termination, Halter was STC's part-time bookkeeper. Both Halters were signatories on the bank accounts, but Halter, Jr. ceded full responsibility for STC's accounting records and bank accounts to his father. Through the end of 2008, Halter handled all of STC's bank transfers and reconciliations. Halter had electronic access to the STC-controlled bank accounts, and routinely made transfers among those accounts. Halter, Jr. only occasionally looked at bank statements, and neither he nor anyone else at STC reviewed his father's funds transfers, bank reconciliations or other work during the period that Halter misappropriated funds.

6. From August 2007 through November 2008, Halter transferred a total of approximately $2.7 million from ten STC client accounts to his brokerage account or other accounts he controlled.

7. Halter diverted most of the money from an STC escrow account for a client's securities offering. Under the terms of the escrow agreement, STC agreed to hold $2 million in proceeds from the offering until the client met certain financial requirements. The escrow account was opened in July 2007, and the next month Halter diverted $600,000 from the account. Later that year he repaid part of that amount, but during March through July 2008, he misappropriated an additional $1.575 million from the account. As a result, for most of the escrow period, the client account contained substantially less than the $2 million escrow amount. Thus, had anyone besides Halter reviewed the bank statements for the client account, his misappropriations would have been detected.

8. In late November 2008, the client notified STC that the requirements for release of the escrow had been met. In order to replenish the client escrow account and make the required payment, Halter misappropriated $1.291 million from seven additional issuer accounts and deposited it into the client account in late November 2008.

9. Halter also misappropriated $150,000 from STC's dividend payment account for an issuer in August 2007, and he misappropriated $400,000 from an account STC maintained for another issuer in September 2008.

10. Immediately after discovering that Halter had misappropriated client funds, Halter, Jr. terminated him and reported the matter to the Commission. Within the same month, Halter repaid all of the funds he misappropriated from STC's issuer clients and the clients were all made whole.

11. As president and control person of STC, Halter, Jr. was responsible for ensuring that STC had adequate supervisory procedures and a system for applying such procedures. STC, however, merely had limited procedures to assure that client accounts and funds were secure from outside access, copying, or theft. STC essentially had no procedures to safeguard client funds from internal, employee abuse. STC's procedures did not require multiple signatures or approvals to transfer funds, and they did not provide for subsequent review and monitoring of financial transactions.

12. Thus, STC's procedures did not include appropriate checks and balances to ensure that issuer funds were not misappropriated by employees who had electronic access to the accounts or who had signatory authority over the accounts. As a result, STC's supervisory procedures relating to the safeguarding of funds were inadequately designed to prevent and detect employee abuse, such as Halter's misappropriations.

13. As a result of the conduct described above, STC violated Section 17A(d)(1) of the Exchange Act and Rule 17Ad-12(a)(2) thereunder, which prohibit a transfer agent from engaging in any activity that fails to assure that all funds held in its custody or possession, and related to its transfer agent activities, are protected.

14. Under Sections 17A(c)(3) and 17A(c)(4) of the Exchange Act, the Commission may sanction transfer agents or associated persons of transfer agents who have, among other things, failed reasonably to supervise, with a view to preventing violations of the securities laws, another person who commits such a violation, if such other person is subject to his supervision. Halter, Jr., as president and control person of STC, failed to ensure that STC adopted and implemented procedures, and a system for applying such procedures, that would reasonably be expected to detect and prevent violations of the federal securities laws, in this case misapplications or misappropriations of customer funds. As a result, Halter, Jr. and STC failed reasonably to supervise Halter.

Respondent's Remedial Efforts

15. In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondent and cooperation afforded the Commission staff.

Undertakings

STC undertakes to:

16. Retain within 30 days after entry of this Order, the services of an Independent Consultant, acceptable to the Commission's staff, and thereafter exclusively bear all costs, including compensation and expenses, associated with the retention of the Independent Consultant. STC shall retain the Independent Consultant to conduct a comprehensive review of, and recommend corrective measures concerning, its policies and procedures relating to handling of client funds and securities. STC shall cooperate fully with the Independent Consultant and shall provide the Independent Consultant with access to STC's files, books, records and personnel as reasonably requested.

17. No more than 120 days after the date of the entry of this Order, submit to the staff of the Commission a written report that STC will obtain from the Independent Consultant regarding STC's policies and procedures. The report will include a description of the review performed, the conclusions reached, the Independent Consultant's recommendations for changes in or improvements to the policies and procedures, and a procedure for implementing any recommended changes.

18. Adopt all recommendations made by the Independent Consultant, provided, however, that within 150 days after the date of the entry of this Order, STC will in writing advise the Independent Consultant and the staff of the Commission of any recommendations it considers unnecessary or inappropriate. With respect to any recommendation that STC considers unnecessary or inappropriate, STC need not adopt that recommendation at that time, but instead propose in writing an alternative policy, procedure, or system designed to achieve the same objective or purpose. As to any recommendation with respect to STC's policies and procedures on which STC and the Independent Consultant do not agree, they will attempt in good faith to reach an agreement within 180 days of the date of entry of this Order. In the event STC and the Independent Consultant are unable to agree on an alternative proposal, STC will abide by the determinations of the Independent Consultant.

19. To ensure the independence of the Independent Consultant, STC: (i) shall not have authority to terminate the Independent Consultant, without the prior written approval of the Commission's staff; (ii) shall compensate the Independent Consultant, and persons engaged to assist the Independent Consultant, for services rendered pursuant to this Order at their reasonable and customary rates; (iii) shall not be in and shall not have an attorney-client relationship with the Independent Consultant, and shall not seek to invoke the attorney-client or any other doctrine or privilege to prevent the Independent Consultant from transmitting any information, reports, or documents to the Commission or the Commission's staff.

20. Require the Independent Consultant to enter into an agreement that provides that for the period of engagement and for a period of two years from completion of the engagement, the Independent Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with STC, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity. The agreement will also provide that the Independent Consultant will require that any firm with which he/she is affiliated or of which he/she is a member, and any person engaged to assist the Independent Consultant in performance of his/her duties under this Order shall not, without prior written consent of the staff of the Commission, enter into any employment, consultant, attorney-client, auditing or other professional relationship with STC, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement.

21. Halter, Jr. shall provide to the Commission, within 30 days after the end of the three month supervisory suspension period described below, an affidavit that he has complied fully with the sanctions described in Section IV below.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondents' Offer.

Accordingly, pursuant to Sections 17A and 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondent STC shall cease and desist from committing or causing any violations and any future violations of Section 17A(d)(1) of the Exchange Act and Rule 17Ad-12(a)(2) thereunder.

B. Respondent STC is censured.

C. Respondent Halter, Jr. shall cease and desist from committing or causing any violations and any future violations of Section 17A(d)(1) of the Exchange Act and Rule 17Ad-12(a)(2) thereunder.

D. Respondent Halter, Jr. be, and hereby is, suspended from association in a supervisory capacity with any transfer agent, broker, dealer, investment adviser, municipal securities dealer, municipal advisor, or nationally recognized statistical ratings organization for a period of three months, effective on the second Monday following the entry of this Order.

E. Respondent STC shall, within 30 days of the entry of this Order, pay a civil money penalty in the amount of $10,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Such payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Alexandria, VA 22312-0003; and (D) submitted under cover letter that identifies STC as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and wire transfer, money order or check shall be sent to Stephen J. Korotash, Associate Director, Division of Enforcement, Securities and Exchange Commission, 801 Cherry Street, Suite 1900, Fort Worth, Texas 76102.

F. Respondent STC shall certify, in writing, compliance with the undertakings set forth above. The certification shall identify the undertakings, provide written evidence of compliance in the form of a narrative and be supported by exhibits sufficient to demonstrate compliance. The Commission staff may make reasonable requests for further evidence of compliance, and Respondent agrees to provide such evidence. The certification and supporting material shall be submitted to Barbara Gunn, Assistant Regional Director, Fort Worth Regional Office, 801 Cherry

Street, Suite 1900, Fort Worth, Texas, 76109, with a copy to the Office of Chief Counsel of the Enforcement Division, no later than sixty (60) days from the date of the completion of the undertakings.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9195 / March 4, 2011

SECURITIES EXCHANGE ACT OF 1934
Release No. 64035 / March 4, 2011

INVESTMENT COMPANY ACT OF 1940
Release No. 29595 / March 4, 2011

INVESTMENT ADVISERS ACT OF 1940
Release No. 3170 / March 4, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14286

In the Matter of

SBM INVESTMENT CERTIFICATES, INC. f/k/a/ 1st ATLANTIC GUARANTY CORP., SBM CERTIFICATE COMPANY, GENEVA CAPITAL PARTNERS, LLC and ERIC M. WESTBURY, SR.

Respondents.

ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933 AND SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940 AND SECTIONS 9(b) AND 9(f) OF THE INVESTMENT COMPANY ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Investment Company Act") against SBM Investment Certificates, Inc. f/k/a/ 1st Atlantic Guaranty Corp. ("SBMIC"), SBM Certificate Company ("SBMCC"), Geneva Capital Partners, LLC ("Geneva") and Eric M. Westbury, Sr. (collectively "Respondents").

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the "Offers") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Section 21C of the Securities Exchange Act of 1934, Section 203(f) of the Investment Advisers Act of 1940 and Sections 9(b) and 9(f) of the Investment Company Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondents' Offers, the Commission finds[1] that:

A. Summary

This matter arises from the failure of two face-amount certificate companies, SBMIC and SBMCC, registered with the Commission pursuant to Section 8(a) of the Investment Company Act, 15 U.S.C. § 80a-8(a), to maintain adequate qualified reserves and to fully and truthfully disclose to investors material facts related to the financial condition and operations of the companies during the time period of January 1, 2003 through April 4, 2006 (the "relevant period"). In addition, this matter involves the offer to sell fixed interest rate investment certificates by Geneva, the parent of SBMIC and SBMCC, and the failure of Geneva to fully and truthfully disclose material information regarding these investments as well as misstatements concerning assets held in Geneva's custody on behalf of a purchaser of these fixed interest rate certificates.

B. Respondents

1. **SBM Investment Certificates, Inc. f/k/a 1st Atlantic Guaranty Corporation** has been a Maryland corporation since 1997 with its principal place of business in Vienna, Virginia. SBMIC has been registered with the Commission as a face-amount certificate company since

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[1] The findings herein are made pursuant to Respondents' Offers of Settlement and are not binding on any other person or entity in this or any other proceeding.

January 1991. Westbury is the Chairman of the Board, Chief Executive Officer and President of SBMIC, and SBMIC is wholly-owned by Geneva Capital Partners, LLC.

2. **SBM Certificate Company** was originally incorporated in Minnesota in June 1990 to assume the face-amount certificate business of SBM Company, which commenced operations in 1914. SBMCC has been registered with the Commission as a face-amount certificate company under Section 8(a) of the Investment Company Act since January 1991. It was reincorporated in Maryland in 2000 and its principal place of business is in Vienna, Virginia. Westbury is the Chairman of the Board, Chief Executive Officer and President of SBMCC. SBMCC is wholly-owned by SBM Financial LLC, which is wholly-owned by SBM Financial Group, a holding company owned by Geneva Capital Partners, LLC.

3. **Geneva Capital Partners, LLC** is a limited liability company organized under the laws of Delaware with its principal place of business in Silver Spring, Maryland. Geneva is an unregistered entity that is wholly owned by Geneva Financial Holdings, LLC, a holding company that is owned principally by Westbury.

4. **Eric M. Westbury, Sr.**, age 47, is a resident of Silver Spring, Maryland. He is Chairman of the Board, Chief Executive Officer and President of both SBMIC and SBMCC. He is associated with an investment adviser and he is the owner and operator of Geneva Financial Holdings, LLC which wholly owns and operates Geneva. Prior to Geneva's acquisition of the stock of SBMIC and SBMCC, Westbury served as President of SBMCC and Executive Vice-President of SBMIC.

C. Background – Face Amount Certificate Companies

5. A face-amount certificate company, defined in Section 2(a)(15) of the Investment Company Act, is a specialized type of investment company that issues fixed-income debt securities; these companies agree to pay the principal amount of the instruments (the "face-amount") at maturity, plus periodic interest over the lifetime of the certificate or accrued interest on maturity. The profitability of face-amount certificate companies depends upon the difference between the return they generate on their investment portfolios and the expenses incurred from selling and satisfying certificate obligations.

6. In accordance with Section 28(a) of the Investment Company Act, face-amount certificate companies such as SBMIC and SBMCC are required to maintain reserves equal to the surrender value of the certificates issued plus interest, plus capital stock of not less than $250,000 that is paid for in cash.

7. Section 28(b) of the Investment Company Act requires that the reserves maintained by such companies be cash or "qualified investments" having a value not less than the aggregate amount of the capital stock requirement and the maturity amount of the outstanding certificates when due. To insure the liquidity required for payments and withdrawals, Section 28(b) specifies the type of "qualified investments" (also referred to as "qualified assets") that must be used to satisfy reserve requirements.

8. Under Section 28(b) of the Investment Company Act, qualified assets are defined as "investments of a kind which life insurance companies are permitted to invest in or hold under the provisions of the Code of the District of Columbia."

D. SBMIC, SBMCC and Westbury

9. SBMCC maintains outstanding face-amount certificates that have fixed guarantee periods of three, five, seven, and ten years. Of these four types of certificates, three have a maturity of 30 years; the seven year guarantee period certificates have a maturity of 28 years.

10. SBMIC maintains outstanding face-amount certificates that have fixed guarantee periods of one, three, five and ten years. All of SBMIC's certificates mature in 20 years.

11. During the relevant period, Westbury was the President and Chief Executive Officer of SBMCC and became the Chairman of the Board of Directors on January 28, 2004. Also, during the relevant period, Westbury was the President of SBMIC. In these positions Westbury controlled SBMIC and SBMCC and was aware of, and in certain instances directed, the conduct described below.

12. As of April 4, 2006, over 2,000 investors had over $37 million invested in SBMIC and SBMCC certificates.

13. During the relevant period, SBMIC and SBMCC did not maintain sufficient qualified assets to meet the requirements of Sections 28(a) and (b) of the Investment Company Act.

14. SBMCC was under reserved during the relevant time period, including but not limited to, by no less than $1.962 million at the close of 2003, $4.943 million as of the close of the first quarter of 2004, $9.057 million by the close of 2004, and $14.185 million by the close of 2005.

15. According to SBMIC records, SBMIC was required to maintain certificate reserves of approximately $5.246 million at the close of 2003 and approximately $2.545 million at the close of 2004.

16. SBMIC was under reserved during the relevant period, including but not limited to, by no less than $541,981 at the close of 2003, or 10% below the required reserve amount, and $366,236 by the close of 2004, or 14% below the required reserve amount.

17. During the relevant period, SBMIC accepted new investments from certain existing certificate holders.

18. During the relevant period, both SBMIC and SBMCC continued to sell securities by permitting, and in many instances soliciting, existing certificate holders to "roll over" their invested capital.

19. While both SBMIC and SBMCC continued to sell securities, they failed to disclose, and in some instances misrepresented, to purchasers material facts, including, but not limited to, the deteriorating financial condition of the companies, the lack of sufficient qualified reserves to satisfy outstanding obligations to certificate holders, the purchase of unqualified assets, the overvaluing of certain qualified assets and the pledging of certain SBMCC reserve assets to secure obligations of Geneva to the District of Columbia Department of Banking.

20. For example, SBMCC failed to disclose an interested transaction that, while recorded and represented in public filings as an SBMCC qualified asset having a value as high as approximately $1.3 million, was undocumented and worthless.

21. In addition, SBMCC recorded and represented in public filings certain purported mortgage notes held for sale as qualified assets when these assets were not owned by SBMCC.

22. Pursuant to Section 30 of the Investment Company Act, SBMCC was required to file Forms 10-K and 10-Q during the relevant time period. SBMCC did not file its Forms 10-K for the years 2004 and 2005. Further, SBMCC failed to file its Form 10-Q for each quarter from the second quarter of 2004 through the remainder of the relevant period.

23. SBMCC's financial condition deteriorated over the relevant period. SBMCC, with Westbury's knowledge, disclosed in a public filing in 2008 that SBMCC's total investment income declined from $2.705 million in 2003 to $1.198 million in 2004 and $583,000 in 2005. Net investment losses rose from $1.879 million in 2003 to $4.051 million in 2004 and $4.958 million in 2005. Overall, SBMCC suffered a net loss of $2.487 million in 2003 that rose to $5.243 million in 2004 and $5.805 million in 2005.

24. During the relevant period, Geneva made significant capital contributions to SBMIC and SBMCC so that SBMIC and SBMCC could satisfy ongoing obligations to pay interest on certificates and expenses from operations. SBMIC and SBMCC's declining investment income was insufficient to pay such interest and expenses.

25. Despite the knowledge and understanding of these facts, during the relevant period SBMIC and SBMCC failed to inform purchasers of material information and, in the instance of SBMCC, encouraged certain certificate holders to roll over investments by falsely describing the investment as providing "a safe investment vehicle, excellent earnings, and flexibility." The misrepresentations and associated omissions by SBMIC and SBMCC described above, known to and directed by Westbury, misled investors.

E. Geneva and Westbury

26. Geneva issued two investment notes to the District of Columbia Department of Banking: Investment Note 227507 dated August 28, 2003, in the amount of $10,000,000; and Investment Note 227509 dated July 9, 2004, in the amount of $5,666,370 ("Investment Notes"). Westbury signed these notes on behalf of Geneva.

27. To pay for these notes, the District of Columbia Department of Banking used District and federal funds earmarked for the District of Columbia Charter School Credit Enhancement Fund, which provides loans and guarantees to charter schools to improve their creditworthiness so that commercial financial institutions will be more willing to make loans to, and/or participate in bond issues, for the particular charter school's capital improvements.

28. During the relevant time period, the District of Columbia also delivered to Geneva for the benefit of the Department of Banking and Financial Institution Credit Enhancement Program an additional approximate $5 million in cash and securities earmarked for the District of Columbia Charter School Credit Enhancement Fund.

29. At the time of the purchase of the Investment Notes by the District of Columbia Department of Banking and thereafter, Westbury and Geneva failed to adequately disclose, and misrepresented, the manner in which the proceeds from the issuance of the notes purchased by the District of Columbia Department of Banking would be invested and the safety of such investments.

30. In addition, Geneva and Westbury falsely represented to the District of Columbia Department of Banking that certain SBMCC assets were available as collateral to satisfy an obligation of Geneva to the District of Columbia Department of Banking. They also failed to disclose conflicts of interest involving Geneva employees or directors of affiliates who also held positions with the District of Columbia and were involved with the selection and distribution of funds to Geneva from the District of Columbia Department of Banking.

31. With regard to the $5 million of cash and securities delivered by the District of Columbia Department of Banking, Westbury and Geneva failed to maintain these assets in the manner agreed to by the parties and failed to correctly report the value and composition of these assets to the District of Columbia Department of Banking.

F. Violations

32. As a result of the conduct described above concerning the operations of SBMIC and SBMCC, including but not limited to misrepresentations and omissions regarding the declining and precarious condition of SBMIC and SBMCC, the lack of sufficient qualified reserves to satisfy outstanding obligations to certificate holders, the purchase of unqualified assets, the overvaluing of certain qualified assets and the pledging of certain SBMCC reserve assets to secure obligations of Geneva to the District of Columbia Department of Banking, Respondents SBMIC, SBMCC and Westbury willfully violated the federal securities laws, as follows:

a. SBMIC and SBMCC violated Sections 28(a) and (b) of the Investment Company Act;

b. SBMIC, SBMCC and Westbury violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder, which prohibit fraudulent conduct in the offer or sale of securities and in connection with the purchase or sale of securities.

33. As a result of the conduct described above concerning the offer or sale of securities by Geneva, including but not limited to the manner in which the District of Columbia Department of Banking assets would be invested and the safety of such investments, falsely representing to the District of Columbia Department of Banking that certain assets were available as collateral, and failing to disclose conflicts of interest, Respondents Geneva and Westbury willfully violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder, which prohibit fraudulent conduct in the offer or sale of securities and in connection with the purchase or sale of securities.

G. Undertakings

34. Within sixty (60) days of the entry of this Order, Westbury will no longer be an affiliated person, as defined in Section 2(a)(3) of the Investment Company Act (or an affiliated person of an affiliated person), of SBM Financial, LLC, the investment adviser to SBMIC and SBMCC, and will not in the future be an affiliated person (or affiliated person of an affiliated person) of any investment adviser to SBMIC and SBMCC.

35. Upon entry of this Order, Westbury will no longer serve as President of SBMIC and SBMCC. Westbury will remain as Chairman and Chief Executive Officer of SBMIC and SBMCC to ensure that SBMIC and SBMCC comply with the undertakings imposed by the United States District Court for the District of Maryland in the action captioned Securities and Exchange Commission v. SBM Investment Certificates, Inc. et al, 8:06-cv-00866-DKC ("Civil Action"). Upon termination of the independent consultant's duties as ordered by the Court in the Civil Action, Westbury will no longer serve in any officer, director, employee or consulting positions or capacities with SBMIC and SBMCC, and will no longer be involved in the daily operations or investment decisions of those entities.

36. Respondents shall certify, in writing, compliance with the undertakings set forth above. The certification shall identify the undertakings, provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. The Commission staff may make reasonable requests for further evidence of compliance, and Respondent agrees to provide such evidence. The certification and supporting material shall be submitted to G. Jeffrey Boujoukos, Regional Trial Counsel, Philadelphia Regional Office, with a copy to the Office of Chief Counsel of the Division of Enforcement, no later than sixty (60) days from the date of the completion of the undertakings.

37. In determining whether to accept the Offers, the Commission has considered these undertakings.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to accept the Offers submitted by the Respondents and impose the sanctions agreed to in Respondents' Offers.

Accordingly, pursuant to Section 8A of the Securities Act, Section 21C of the Exchange Act and Section 9(f) of the Investment Company Act with regard to SBMIC and SBMCC, Section 8A of the Securities Act, Section 21C of the Exchange Act, Section 203(f) of the Advisers Act, and Section 9(b) of the Investment Company Act with regard to Westbury, and Section 8A of the Securities Act and Section 21C of the Exchange Act, with regard to Geneva, it is hereby ORDERED that:

1. Respondent Westbury is censured.

2. Respondents SBMIC, SBMCC, Geneva and Westbury shall cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder.

3. Respondent Westbury shall pay a civil money penalty in the amount of $130,000 to the United States Treasury. Payment shall be made in the following installments: (a) $43,000, within thirty (30) days of the issuance of this Order, (b) $29,000 within one hundred and twenty (120) days of the issuance of this Order, (c) $29,000 within two hundred and forty (240) days of the issuance of this Order and (d) $29,000 within 360 days of the issuance of this Order. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of civil penalties, plus any additional interest accrued pursuant to 31 U.S.C. § 3717, shall be due and payable immediately, without further application. Payments shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Westbury as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to G. Jeffrey Boujoukos, Regional Trial Counsel, United States Securities and Exchange Commission, 701 Market Street, Suite 2000, Philadelphia, PA 19106.

4. Respondents SBMIC, SBMCC and Westbury shall ensure that SBMIC and SBMCC comply with the undertakings imposed by the United States District Court for the District of Maryland in the action captioned Securities and Exchange Commission v. SBM Investment Certificates, Inc. et al, 8:06-cv-00866-DKC.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

March 8, 2011

In the Matter of **AccessTel, Inc.,** **American Asset Management Corp.,** **DME Interactive Holdings, Inc.,** **DocuPort, Inc., and** **iCarbon Corp.,** **File No. 500-1**	**ORDER OF SUSPENSION OF TRADING**

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of AccessTel, Inc. because it has not filed any periodic reports since the period ended March 31, 2005.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of American Asset Management Corp. because it has not filed any periodic reports since the period ended March 31, 2005.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of DME Interactive Holdings, Inc. because it has not filed any periodic reports since the period ended March 31, 2001.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of DocuPort, Inc. because it has not filed any periodic reports since the period ended September 30, 2000.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of iCarbon Corp. because it has not filed any periodic reports since the period ended December 31, 2006.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed companies. Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed companies is suspended for the period from 9:30 a.m. EST on March 8, 2011, through 11:59 p.m. EDT on March 21, 2011.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64048 / March 8, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14287

In the Matter of **AccessTel, Inc.,** **American Asset Management Corp.,** **DME Interactive Holdings, Inc.,** **DocuPort, Inc., and** **iCarbon Corp.,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents AccessTel, Inc., American Asset Management Corp., DME Interactive Holdings, Inc., DocuPort, Inc., and iCarbon Corp.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. AccessTel, Inc. ("ACCS")[1] (CIK No. 1063293) is an expired Utah corporation located in Fairfield, New Jersey with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). ACCS is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2005. As of March 3, 2011, the common stock of ACCS was quoted on OTC Link, had six market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

2. American Asset Management Corp. ("AAMC") (CIK No. 852015) is a New Jersey corporation located in Parsippany, New Jersey with a class of securities

[1]The short form of each issuer's name is also its stock symbol.

registered with the Commission pursuant to Exchange Act Section 12(g). AAMC is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2005, which reported a net loss of $119,965 for the prior three months. As of March 3, 2011, the common stock of AAMC was quoted on OTC Link, had seven market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

3. DME Interactive Holdings, Inc. ("DMEI") (CIK No. 1004124) is a void Delaware corporation located in Englewood, New Jersey with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). DMEI is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2001, which reported a net loss of $334,915 for the prior three months. As of March 3, 2011, the common stock of DMEI was quoted on OTC Link, had four market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

4. DocuPort, Inc. ("DCPT") (CIK No. 1019648) is a void Delaware corporation located in Fairfield, New Jersey with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). DCPT is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2000, which reported a net loss of $2,416,072 for the prior nine months. As of March 3, 2011, the common stock of DCPT was quoted on OTC Link, had four market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

5. iCarbon Corp. ("ICRB") (CIK No. 1093818) is a revoked Nevada corporation located in Delano, Pennsylvania with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). ICRB is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended December 31, 2006, which reported a net loss of $4,659,237 for the prior nine months. As of March 3, 2011, the common stock of ICRB was quoted on OTC Link, had five market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

B. DELINQUENT PERIODIC FILINGS

6. As described in more detail above, all of the respondents are delinquent in their periodic filings with the Commission, have repeatedly failed to meet their obligations to file timely periodic reports, and failed to heed delinquency letters sent to them by the Division of Corporation Finance requesting compliance with their periodic filing obligations or, through their failure to maintain a valid address on file with the Commission as required by Commission rules, did not receive such letters.

7. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers of securities registered pursuant to Exchange Act Section 12 to file with the Commission current and accurate information in periodic reports, even if the registration is voluntary under Section 12(g). Specifically, Rule 13a-1 requires issuers to file annual reports, and Rule 13a-13 requires domestic issuers to file quarterly reports

8. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate for the protection of investors that public administrative proceedings be instituted to determine:

A. Whether the allegations contained in Section II hereof are true and, in connection therewith, to afford the Respondents an opportunity to establish any defenses to such allegations; and,

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or revoke the registration of each class of securities registered pursuant to Section 12 of the Exchange Act of the Respondents identified in Section II hereof, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents.

IV.

IT IS HEREBY ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice [17 C.F.R. § 201.110].

IT IS HEREBY FURTHER ORDERED that Respondents shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220(b) of the Commission's Rules of Practice [17 C.F.R. § 201.220(b)].

If Respondents fail to file the directed Answers, or fail to appear at a hearing after being duly notified, the Respondents, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents, may be deemed in default and the proceedings may be determined against it upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means permitted by the Commission Rules of Practice.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 120 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice [17 C.F.R. § 201.360(a)(2)].

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64049 / March 8, 2011

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3251 / March 8, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14288

In the Matter of	
	ORDER OF SUSPENSION PURSUANT TO RULE 102(e)(2) OF THE COMMISSION'S RULES OF PRACTICE
SUJATA SACHDEVA,	
Respondent.	

I.

The Securities and Exchange Commission deems it appropriate to issue an order of forthwith suspension of Sujata Sachdeva ("Sachdeva") pursuant to Rule 102(e)(2) of the Commission's Rules of Practice [17 C.F.R. § 200.102(e)(2)].[1]

II.

In anticipation of the institution of these proceedings, Sachdeva has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over her and the subject matter of these proceedings, and the findings contained in Section III.2. below, which are admitted, Respondent consents to the entry of this Order of Suspension Pursuant to Rule 102(e)(2) of the Commission's Rules of Practice ("Order"), as set forth below.

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1 Rule 102(e)(2) provides in pertinent part: "Any ... person who has been convicted of a felony or a misdemeanor involving moral turpitude shall be forthwith suspended from appearing or practicing before the Commission."

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. Sachdeva, age 46, is a resident of Mequon, Wisconsin. From 1992 through her termination on December 23, 2009, Sachdeva was Principal Accounting Officer, Secretary, and Vice-President of Finance of Koss Corporation ("Koss"). Koss securities are registered pursuant to Section 12(b) of the Securities Exchange Act of 1934 and trade on the NASDAQ Global Market.

2. On July 16, 2010, Sachdeva pleaded guilty to six counts of wire fraud, in violation of 18 U.S.C. Section 1343, before the United States District Court for the Eastern District of Wisconsin in United States v. Sujata Sachdeva, Case No. 10-CR-6. On November 17, 2010, the court in the criminal case entered judgment and sentenced Sachdeva to a prison term of 132 months, followed by 3 years of supervised release, and ordered Sachdeva to make restitution in the amount of $34 million.

3. The counts of the criminal indictment to which Sachdeva pleaded guilty alleged, inter alia, that Sachdeva defrauded Koss and obtained money and property by means of material false and fraudulent pretenses and representations and did knowingly cause wire communications to be transmitted in interstate commerce for the purpose of executing her scheme.

III.

In view of the foregoing, the Commission finds that Sachdeva has been convicted of a felony within the meaning of Rule 102(e)(2) of the Commission's Rules of Practice.

Accordingly, it is ORDERED that Sujata Sachdeva is forthwith suspended from appearing or practicing before the Commission pursuant to Rule 102(e)(2) of the Commission's Rules of Practice.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64063 / March 9, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14289

In the Matter of AdAl Group, Inc., Com/Tech Communications Technologies, Inc., Dialog Group, Inc., Eurogas, Inc., Golden Books Family Entertainment, Inc. (n/k/a GB Holdings Liquidation, Inc.), Information Management Technologies Corporation, Interiors, Inc., and SFG Financial Corp., Respondents.	ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents AdAl Group, Inc., Com/Tech Communications Technologies, Inc., Dialog Group, Inc., Eurogas, Inc., Golden Books Family Entertainment, Inc. (n/k/a GB Holdings Liquidation, Inc.), Information Management Technologies Corporation, Interiors, Inc., and SFG Financial Corp.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. AdAl Group, Inc. ("ADGR") [1] (CIK No. 810370) is a void Delaware corporation located in New York, New York with a class of securities registered with the Commission

[1] The short form of each issuer's name is also its stock symbol.

pursuant to Exchange Act Section 12(g). ADGR is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2005, which reported a net loss of $3,813,000 for the prior nine months. As of March 3, 2011, the common stock of ADGR was quoted on OTC Link, had six market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

2. Com/Tech Communication Technologies, Inc. ("CMTK") (CIK No. 945640) is a dissolved New York corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). CMTK is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended December 31, 1996, which reported a net loss of $1,361,053 for the prior nine months. As of March 3, 2011, the common stock of CMTK was quoted on OTC Link, had four market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

3. Dialog Group, Inc. ("DLGO") (CIK No. 1051059) is a void Delaware corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). DLGO is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2007, which reported a net loss of $648,002 for the prior nine months. As of March 3, 2011, the common stock of DLGO was quoted on OTC Link, had six market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

4. Eurogas, Inc. ("EUGS") (CIK No. 783209) is a Utah corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). EUGS's Forms 10-K for the periods ended December 31, 2007, 2008 and 2009 failed to include audited financial statements as required by Commission rules. Similarly, the financial statements filed with EUGS's Forms 10-Q for the interim periods from March 31, 2007 through September 30, 2010, inclusive, were not reviewed by an independent auditing firm, as required by Commission rules. EUGS's Form 10-Q for the period ended September 30, 2010 reported a net loss of $1,267,550 for the prior nine months. On November 23, 2004, EUGS was the subject of an involuntary Chapter 7 petition in the U.S. Bankruptcy Court for the District of Utah, which was closed on March 19, 2007. As of March 3, 2011, the common stock of EUGS was quoted on OTC Link, had fifteen market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

5. Golden Books Family Entertainment, Inc. (n/k/a GB Holdings Liquidation, Inc.) ("GBKF") (CIK No. 790706) is a forfeited Delaware corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). GBKF is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended March 31, 2001, which reported a net loss of $9,004,000 for the prior three months. On June 4, 2001, GBKF filed a Chapter 11 petition in the U.S. Bankruptcy Court for the District of Delaware, which was terminated on March 3, 2003. As of March 3, 2011, the common stock of GBKF was quoted on OTC Link, had four market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

6. Information Management Technologies Corporation ("IMTKA") (CIK No. 824578) is a forfeited Delaware corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). IMTKA is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended June 30, 1999, which reported a net loss of $67,304 for the prior three months. On October 7, 1992, IMTKA and its wholly owned subsidiary, INSCI Corp., consented to the entry of an order permanently enjoining them from committing or aiding and abetting any violations of Exchange Act Sections 10(b), 13(a), 13(b), 17A, and Rules 10b-5, 12b-20, 13a-1, 13a-13 and 13b2-1 thereunder. *SEC v. Information Management Technologies Corp., et al.*, 92-Civ-7108 (S.D.N.Y. Oct. 7, 1992). See also Litigation Rel. No. 13398, (Oct. 6, 1992). As of March 3, 2011, the common stock of IMTKA was quoted on OTC Link, had three market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

7. Interiors, Inc. ("INRSA") (CIK No. 921563) is a void Delaware corporation located in Braintree, Massachusetts with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). INRSA is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2002, which reported a net loss of $25,179,000 for the prior nine months. As of March 3, 2011, the common stock of INRSA was quoted on OTC Link, had six market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3). As of March 3, 2011, the preferred shares of INRSA (symbol "INRSP") were quoted on OTC Link, had two market makers, and were eligible for the ""piggyback"" exception of Exchange Act Rule 15c2-11(f)(3).

8. SFG Financial Corp. ("SFGF") (CIK No. 751418) is a void Delaware corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). SFGF is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-KSB for the period ended January 31, 2008, which reported a net loss of $15,385,370 for the prior year. As of March 3, 2011, the common stock of SFGF was quoted on OTC Link, had six market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

B. DELINQUENT PERIODIC FILINGS

9. As discussed in more detail above, all of the Respondents are delinquent in their periodic filings with the Commission, have repeatedly failed to meet their obligations to file timely periodic reports, and failed to heed delinquency letters sent to them by the Division of Corporation Finance requesting compliance with their periodic filing obligations or, through their failure to maintain a valid address on file with the Commission as required by Commission rules, did not receive such letters.

10. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers of securities registered pursuant to Exchange Act Section 12 to file with the Commission current and accurate information in periodic reports, even if the registration is voluntary under Section 12(g). Specifically, Rule 13a-1 requires issuers to file annual reports, and Rule 13a-13 requires issuers to file quarterly reports.

11. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate for the protection of investors that public administrative proceedings be instituted to determine:

A. Whether the allegations contained in Section II hereof are true and, in connection therewith, to afford the Respondents an opportunity to establish any defenses to such allegations; and,

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or revoke the registration of each class of securities registered pursuant to Section 12 of the Exchange Act of the Respondents identified in Section II hereof, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents.

IV.

IT IS HEREBY ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice [17 C.F.R. § 201.110].

IT IS HEREBY FURTHER ORDERED that Respondents shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220(b) of the Commission's Rules of Practice [17 C.F.R. § 201.220(b)].

If Respondents fail to file the directed Answers, or fail to appear at a hearing after being duly notified, the Respondents, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents, may be deemed in default and the proceedings may be determined against it upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means permitted by the Commission Rules of Practice.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 120 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice [17 C.F.R. § 201.360(a)(2)].

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Chairman Schapiro
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9196 / March 9, 2011

SECURITIES EXCHANGE ACT OF 1934
Release No. 64066 / March 9, 2011

INVESTMENT ADVISERS ACT OF 1940
Release No. 3172 / March 9, 2011

INVESTMENT COMPANY ACT OF 1940
Release No. 29598 / March 9, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14033

In the Matter of

NEAL R. GREENBERG,

Respondent.

ORDER DISMISSING PROCEEDINGS

On September 7, 2010, the Commission instituted this public administrative and cease-and-desist proceedings pursuant to Section 8A of the Securities Act of 1933, Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act"), and Section 9(b) of the Investment Company Act of 1940 against Neal R. Greenberg ("Greenberg").

Greenberg consented to entry of a judgment enjoining him from violations of Sections 206(2) and 206(4) of the Advisers Act and Rules 206(4)-2, 206(4)-7, and 206(4)-8 promulgated thereunder, and ordering disgorgement. *See* Civil Action No. 1:11-cv-00313-JLK (D. Colo.). Based on that injunction, the Commission barred Greenberg from association with any broker, dealer, or investment adviser pursuant to Section 15(b) of the Exchange Act and Section 203(f) of the Advisers Act in another administrative proceeding (File No. 3-14269).[1]

[1] Neal R. Greenberg, Exchange Act Release No. 63932, dated February 18, 2011.

The Commission therefore deems it appropriate and in the public interest to dismiss this proceeding.

Accordingly, IT IS ORDERED that this proceeding be, and hereby is, dismissed.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

March 9, 2011

In the Matter of AdAl Group, Inc., Com/Tech Communications Technologies, Inc., Dialog Group, Inc., Eurogas, Inc., Golden Books Family Entertainment, Inc. (n/k/a GB Holdings Liquidation, Inc.), Information Management Technologies Corporation, Interiors, Inc., and SFG Financial Corp., File No. 500-1	ORDER OF SUSPENSION OF TRADING

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of AdAl Group, Inc. because it has not filed any periodic reports since the period ended September 30, 2005.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Com/Tech Communications Technologies, Inc. because it has not filed any periodic reports since the period ended December 31, 1996.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Dialog Group, Inc. because it has not filed any periodic reports since the period ended September 30, 2007.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Eurogas, Inc. because its Forms 10-K for the periods ended December 31, 2007, 2008 and 2009 failed to include audited financial statements and its Forms 10-Q for the interim periods from March 31, 2007 through September 30, 2010, inclusive, were not reviewed by an independent auditing firm, as required by Commission rules.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Golden Books Family Entertainment, Inc. (n/k/a GB Holdings Liquidation, Inc.) because it has not filed any periodic reports since the period ended March 31, 2001.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Information Management Technologies Corporation because it has not filed any periodic reports since the period ended June 30, 1999.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Interiors, Inc. because it has not filed any periodic reports since the period ended March 31, 2002.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of SFG Financial Corp. because it has not filed any periodic reports since the period ended January 31, 2008.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed companies. Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed companies is suspended for the period from 9:30 a.m. EST on March 9, 2011, through 11:59 p.m. EDT on March 22, 2011.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64068 / March 10, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14291

In the Matter of **Admiralty Holding Co.,** **American Consolidated Management Group, Inc.,** **DnC Multimedia Corp.,** **Dorsey Trailers, Inc.** **(n/k/a DT Liquidation, Inc.), and** **ElectraCapital, Inc.** **(a/k/a Electra Capital, Inc.),** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents Admiralty Holding Co., American Consolidated Management Group, Inc., DnC Multimedia Corp., Dorsey Trailers, Inc. (n/k/a DT Liquidation, Inc.), and ElectraCapital, Inc. (a/k/a Electra Capital, Inc.).

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Admiralty Holding Co. ("ADMH") [1] (CIK No. 85684) is a delinquent Colorado corporation located in Atlanta, Georgia with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). ADMH is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2006, which reported a net loss of $2,282,063 for the prior nine months.

[1] The short form of each issuer's name is also its stock symbol.

As of March 3, 2011, the common stock of ADMH was quoted on OTC Link, had six market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

2. American Consolidated Management Group, Inc. ("ACMI") (CIK No. 891713) is an expired Utah corporation located in Greer, South Carolina with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). ACMI is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended March 31, 2006, which reported a net loss of $144,847 for the prior three months. As of March 3, 2011, the common stock of ACMI was quoted on OTC Link, had six market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

3. DnC Multimedia Corp. ("DCNMQ") (CIK No. 1123845) is a dissolved Georgia corporation located in Suwanee, Georgia with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). DCNMQ is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-KSB for the period ended December 31, 2007, which reported a net loss of $2,557,079 for the prior year. On December 19, 2008, DCNMQ filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Southern District of Florida, which was dismissed on June 30, 2009. As of March 3, 2011, the common stock of DCNMQ was quoted on OTC Link, had nine market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

4. Dorsey Trailers, Inc. (n/k/a DT Liquidation, Inc.) ("DSYT") (CIK No. 924117) is a void Delaware corporation located in Atlanta, Georgia with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). DSYT is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended July 1, 2000, which reported a net loss of $1,400,000 for the prior twenty-six weeks. On December 4, 2000, DSYT filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Middle District of Alabama, which was still pending as of March 3, 2011. As of March 3, 2011, the common stock of DSYT was quoted on OTC Link, had four market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

5. ElectraCapital, Inc. (a/k/a Electra Capital, Inc.) ("ECTA") (CIK No. 1139220) is a defaulted Nevada corporation located in Fort Mill, South Carolina with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). ECTA is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2003, which reported a net loss of $194,354 for the prior nine months. As of March 3, 2011, the common stock of ECTA was quoted on OTC Link, had seven market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

B. DELINQUENT PERIODIC FILINGS

6. As discussed in more detail above, all of the Respondents are delinquent in their periodic filings with the Commission, have repeatedly failed to meet their obligations to file timely periodic reports, and failed to heed delinquency letters sent to them by the Division of Corporation Finance requesting compliance with their periodic filing obligations or, through

their failure to maintain a valid address on file with the Commission as required by Commission rules, did not receive such letters.

7. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers of securities registered pursuant to Exchange Act Section 12 to file with the Commission current and accurate information in periodic reports, even if the registration is voluntary under Section 12(g). Specifically, Rule 13a-1 requires issuers to file annual reports, and Rule 13a-13 requires issuers to file quarterly reports.

8. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate for the protection of investors that public administrative proceedings be instituted to determine:

A. Whether the allegations contained in Section II hereof are true and, in connection therewith, to afford the Respondents an opportunity to establish any defenses to such allegations; and,

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or revoke the registration of each class of securities registered pursuant to Section 12 of the Exchange Act of the Respondents identified in Section II hereof, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents.

IV.

IT IS HEREBY ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice [17 C.F.R. § 201.110].

IT IS HEREBY FURTHER ORDERED that Respondents shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220(b) of the Commission's Rules of Practice [17 C.F.R. § 201.220(b)].

If Respondents fail to file the directed Answers, or fail to appear at a hearing after being duly notified, the Respondents, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents, may be deemed in default and the proceedings may be determined against it upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means permitted by the Commission Rules of Practice.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 120 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice [17 C.F.R. § 201.360(a)(2)].

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

March 10, 2011

In the Matter of Admiralty Holding Co., American Consolidated Management Group, Inc., DnC Multimedia Corp., Dorsey Trailers, Inc. (n/k/a DT Liquidation, Inc.), and ElectraCapital, Inc. (a/k/a Electra Capital, Inc.), File No. 500-1	ORDER OF SUSPENSION OF TRADING

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Admiralty Holding Co. because it has not filed any periodic reports since the period ended September 30, 2006.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of American Consolidated Management Group, Inc. because it has not filed any periodic reports since the period ended March 31, 2006.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of DnC Multimedia Corp. because it has not filed any periodic reports since the period ended December 31, 2007.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Dorsey Trailers, Inc. (n/k/a DT Liquidation, Inc.) because it has not filed any periodic reports since the period ended July 1, 2000.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of ElectraCapital, Inc. (a/k/a Electra Capital, Inc.) because it has not filed any periodic reports since the period ended September 30, 2003.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed companies. Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed companies is suspended for the period from 9:30 a.m. EST on March 10, 2011, through 11:59 p.m. EDT on March 23, 2011.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION

Securities Exchange Act of 1934 Release No. 64076 / March 11, 2011

ORDER EXEMPTING THE ADVANCED TECHNOLOGIES GROUP, LTD. PROPOSED DISTRIBUTION PLAN FROM SECTIONS 13(e) AND 14(e) OF THE EXCHANGE ACT AND RULE 13e-4 AND REGULATION 14E THEREUNDER PURSUANT TO EXCHANGE ACT SECTION 36(a)

I. Introduction

Pursuant to Section 36(a) of the Securities Exchange Act of 1934 ("Exchange Act"), the Securities and Exchange Commission ("Commission") is granting the proposed Distribution Plan in SEC v. Advanced Technologies Group, Ltd., Alexander Stelmak and Abelis Raskas, 10 Civ. 4868 (RJS), if approved by the United States District Court for the Southern District of New York as described herein, an exemption from the requirements of Exchange Act Sections 13(e) and 14(e) and Rule 13e-4[1] and Regulation 14E promulgated thereunder, to the extent that, subsequent to the entry of this order, the proposed Distribution Plan effects any issuer tender offer, as defined in Rule 13e-4 under the Exchange Act, in connection with the administration of the proposed Distribution Plan.

II. Background

Defendants Advanced Technologies Group, Ltd. ("ATG") and Alexander Stelmak ("Stelmak") have agreed to consent to the entry of a Final Judgment in a civil action in the United States District Court for the Southern District of New York, without admitting or denying the allegations of the Complaint, in which the Commission alleged that they violated Sections 5(a) and 5(c) of the Securities Act of 1933 ("Securities Act"). The Complaint alleges that, between 1997 and 2006, ATG and Stelmak offered and sold, by means of general solicitation, securities of ATG, Oxford Global Network, Ltd. ("Oxford Global") and Luxury Lounge, Inc. ("Luxury"; together, the "Offerings") in unregistered offerings in the absence of an available exemption. In the same action, Defendant Abelis Raskas ("Raskas") has agreed to consent to the entry of a Final Judgment, without admitting or denying the allegations of the Complaint, in which the Commission alleged that he violated Sections 5(a) and 5(c) of the Securities Act in connection with the Luxury offering.

The Final Judgment requires the Defendants, among other things, to pay disgorgement of $19,186,536.32. To distribute the disgorged amounts to investors, the staff will propose a Distribution Plan for approval by the District Court after circulating the proposed Distribution Plan to investors and providing them with an opportunity to object. As part of that proposed Distribution Plan, and as a condition to the settlement, investors who purchased stock in the Offerings and still hold the stock will be permitted to recover the consideration paid, with

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[1] 17 CFR 240.13e-4.

interest, upon tender of the stock for cancellation. Investors who purchased stock in the Offerings but sold the stock at a loss will be permitted to recover damages measured by the difference between the amounts they received when they sold their shares and the amounts they would be entitled to under the proposed Distribution Plan if they had held their shares.

III. Discussion

ATG is an issuer that has a class of equity securities registered under Section 12 of the Exchange Act, and therefore meets the definition of an issuer in Rule 13e-4(a)(1). To the extent that the proposed Distribution Plan, if approved, will effect an offer of cash in connection with the cancellation of ATG, Oxford Global and Luxury shares, it may be viewed as an issuer tender offer as specified in Rule 13e-4(a)(2), and if so, ATG would be obligated to make a filing and required disclosures in compliance with the tender offer regulatory provisions.

The Commission has determined to grant the proposed Distribution Plan, if approved by the District Court, an exemption from the requirements of Sections 13(e) and 14(e) of the Exchange Act and Rule 13e-4 and Regulation 14E thereunder pursuant to the Commission's general exemptive authority contained in Section 36(a), and finds that an exemption from the tender offer regulatory provisions is consistent with the public interest and the protection of investors. The Commission believes that granting an exemption is warranted because: (1) the investors will receive notice of the proposed Distribution Plan and an opportunity to object to it; (2) the District Court will consider and rule on objections to the proposed Distribution Plan; (3) the District Court will approve and supervise the administration of the Distribution Plan; and (4) Defendants will only play a cooperative role in administering the plan, such as providing investor contact information. Moreover, the exemption will safeguard investors who have been harmed by protecting ATG's assets from dissipation through the administrative costs of compliance with the tender offer regulatory provisions. Under these circumstances, the Commission believes that it is not necessary to require Defendants to comply with the obligations of those provisions.

The Commission therefore finds that the proposed Distribution Plan, if approved, does not constitute a fraudulent, deceptive or manipulative act or practice contemplated by Rule 13e-4 and exempts the proposed Distribution Plan, if approved, from Sections 13(e) and 14(e) of the Exchange Act and the tender offer regulatory provisions promulgated thereunder. This exemption is subject to modification or revocation at any time the Commission determines that such modification or revocation is consistent with the public interest or the protection of investors.

Accordingly, IT IS ORDERED, that pursuant to Exchange Act Section 36(a), an exemption for the proposed Distribution Plan, if approved, from Exchange Act Sections 13(e) and 14(e) and Rule 13e-4 and Regulation 14E promulgated thereunder to the extent the proposed Distribution Plan would constitute an issuer tender offer of securities, hereby is granted; and

IT IS FURTHER ORDERED, that the exemptions granted herein for the proposed Distribution Plan, if approved, pursuant to Sections 13(e) and 14(e) of the Exchange Act, and Rule 13e-4 and Regulation 14E promulgated thereunder, shall become effective upon the date that the United States District Court for the Southern District of New York approves the proposed Distribution Plan as provided herein.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murray
Secretary

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 64077 / March 11, 2011

ACCOUNTING AND AUDITING ENFORCEMENT
Rel. No. 3253 / March 11, 2011

Admin. Proc. File No. 3-14177

In the Matter of CARL W. JASPER, CPA	ORDER DENYING MOTION TO LIFT TEMPORARY SUSPENSION AND DIRECTING HEARING

On January 7, 2011, we issued an order instituting proceedings ("OIP") against Carl W. Jasper, a certified public accountant ("CPA"), pursuant to Commission Rule of Practice 102(e)(3),[1] that temporarily suspended him from appearing or practicing before the Commission

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1 Commission Rule of Practice 102(e)(3), 17 C.F.R. § 201.102(e)(3), provides in pertinent part that:

> (i) The Commission, with due regard to the public interest and without preliminary hearing, may, by order, temporarily suspend from appearing or practicing before it any . . . accountant . . . who has been by name:
>
> > (A) Permanently enjoined by any court of competent jurisdiction, by reason of his or her misconduct in an action brought by the Commission, from violating or aiding and abetting the violation of any provision of the Federal securities laws or of the rules and regulations thereunder; or
> >
> > (B) Found by any court of competent jurisdiction in an action brought by the Commission to which he or she is a party or found by the Commission in any administrative proceeding to which he or she is a party to have violated (unless the violation was found not to have been willful) or aided and abetted the violation of any provision of the Federal securities laws or of the rules and regulations thereunder.

as an accountant.[2] Jasper has filed a petition, pursuant to Rule 102(e)(3)(ii),[3] requesting that his temporary suspension be lifted.

Jasper was Vice President, Chief Financial Officer, and Principal Accounting Officer of Maxim Integrated Products, Inc. ("Maxim") during the period from April 1999 through January 2007.[4] The Commission filed a complaint in the United States District Court for the Northern District of California on December 21, 2007, alleging that Jasper "engaged in a scheme to illegally backdate stock options granted to Maxim employees and directors, concealing millions of dollars in expenses from investors and significantly overstating the Company's income." The complaint also alleged that Jasper "was aware of instances of backdating, and on repeated occasions prepared for the signature of Maxim's then Chief Executive Officer falsely dated option grant approval documents to make it appear as though the options had been granted at the market price on an earlier date." The complaint further alleged that Jasper "also knew, or was reckless in not knowing, that the Company did not properly account for such options or accurately disclose Maxim's option granting practices."

A jury found that Jasper violated the antifraud, books and records, false statements and omissions to accountants and auditors, and false certifications provisions of the federal securities laws. The jury also found that Jasper aided and abetted Maxim's violations of reporting, recordkeeping, and internal controls provisions of the Securities Exchange Act of 1934.[5] On July 21, 2010, the District Court entered a judgment against Jasper permanently enjoining him from

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2 *Carl W. Jasper, CPA*, Securities Exchange Act Rel. No. 63674 (Jan. 7, 2011), 100 SEC Docket 36680, 36680.

3 17 C.F.R. § 201.102(e)(3)(ii).

4 *Jasper*, 100 SEC Docket at 36681. The OIP alleged that Jasper "is and has been a CPA licensed to practice in the State of California" and that Jasper's CPA license was inactive during his tenure at Maxim.

5 The jury found that Jasper violated the antifraud provisions in Exchange Act Section 10(b), 15 U.S.C. § 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5, and Section 17(a)(1) of the Securities Act of 1933, 15 U.S.C. § 77q(a)(1); the books and records provisions of Exchange Act Rule 13b2-1, 17 C.F.R. § 240.13b2-1; the false statements and omissions to accountants and auditors provisions of Exchange Act Rule 13b2-2, 17 C.F.R. § 240.13b2-2; and the false certifications provisions of Exchange Act Rule 13a-14, 17 C.F.R. § 240.13a-14. The jury further found that Jasper aided and abetted Maxim's violations of the issuer reporting requirements in Exchange Act Section 13(a), 15 U.S.C. § 78m(a), and Exchange Act Rules 12b-20, 13a-1, 13a-11, and 13a-13, 17 C.F.R. §§ 240.12b-20, 240.13a-1, 240.13a-11, and 240.13a-13; the books and records provisions of Exchange Act Section 13(b)(2)(A), 15 U.S.C. § 78m(b)(2)(A), and the internal controls provisions of Exchange Act Section 13(b)(2)(B), 15 U.S.C. § 78m(b)(2)(B).

"any future violations of the securities laws or regulations."[6] The judgment also barred Jasper from serving as a director or officer of a publicly-traded company for a period of two years, ordered Jasper to pay a civil monetary penalty of $360,000, and ordered him to reimburse Maxim for bonuses and stock-sale profits in the amount of $1,869,639.

In issuing the OIP, we found that it was "appropriate and in the public interest" that Jasper be temporarily suspended from appearing or practicing before the Commission, based on the District Court's final judgment. We stated that the temporary suspension would become permanent unless Jasper filed a petition challenging it within thirty days of service of the order, pursuant to Rule of Practice 102(e)(3)(ii). We further advised that, pursuant to Rule of Practice 102(e)(3)(iii), upon receipt of such a petition, we would either lift the temporary suspension, set the matter down for hearing, or both.

In his petition, Jasper requests that the temporary suspension be lifted or modified to a limited period "coterminous with the two-year D&O bar" imposed by the District Court. Jasper argues that the jury did not make findings setting forth the specific Maxim options grants with respect to which Jasper had committed violations. According to Jasper, "[i]t is therefore impossible to discern from the verdict how many backdated grants the jury found Mr. Jasper was aware of, the value of the grants, or the extent of his role in backdating." Jasper states that the jury found him not guilty of three of the eleven charges included in the Commission's complaint, and "that the jury asked about the 'responsibility' of various officer for misstatements, suggest[ing] it did not view Mr. Jasper as a ringleader in whatever improprieties it may have found." Jasper claims that a permanent suspension would serve no remedial purpose because he is unlikely to commit future violations "in the absence of [Maxim's then-CEO] and the culture he created at Maxim." Jasper argues that the violations were "not motivated by self-interest (apart from, at best, keeping his job)" and points out his prior lack of any disciplinary history during his twenty-eight year career as an accountant and auditor.

The Division of Enforcement has not filed an opposition to Jasper's petition.

"Rule 102(e)(3) permits the Commission to suspend any accountant or other professional or expert who has been permanently enjoined from violating or aiding and abetting the violation of the Federal securities laws . . . ."[7] Generally, a respondent in a "follow-on" proceeding is precluded from challenging the basis for, or findings in, the underlying injunctive action.[8] At this

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6 *Carl W. Jasper*, Litigation Rel. No. 21598 (July 22, 2010).

7 *Daniel S. Lezak*, 57 S.E.C. 997, 1001 (2004).

8 *Michael Batterman*, 57 S.E.C. 1031, 1039 n.18 (2004); *see also Lezak*, 57 S.E.C. at 1001 (holding that "[t]he findings of the Court, which [the petitioner] is precluded from contesting in this proceeding, as well as the injunction issued against him justify the continuance (continued...)

stage, it appears that the findings made in the injunctive proceeding and the injunction issued against Jasper "justify the continuance of his suspension until it can be determined what, if any, action may be appropriate to protect the Commission's process."[9] As provided in Rule 102(e)(3)(iii), therefore, we will set the matter down for public hearing.

Accordingly, IT IS ORDERED that this proceeding be set down for public hearing before an administrative law judge in accordance with Rule of Practice 110. As specified in Rule of Practice 102(e)(3)(iii), the hearing in this matter shall be expedited in accordance with Rule of Practice 500; it is further

ORDERED that the administrative law judge shall issue an initial decision no later than 210 days from the date of service of this Order; and it is further

ORDERED that the temporary suspension of Carl W. Jasper, entered on January 7, 2011, remain in effect pending a hearing and decision in this matter.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

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[8] (...continued)
of his suspension until it can be determined what, if any, action may be appropriate to protect this Commission's processes").

[9] *William D. Shovers*, Exchange Act Rel. No. 59874 (May 6, 2009), 95 SEC Docket 16512, 16515.

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64078 / March 11, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-12631

In the Matter of Morgan Stanley & Co. Incorporated, Respondent.	ORDER DIRECTING DISBURSEMENT OF DISGORGEMENT FUND

On June 23, 2009, the Commission issued a Notice of the Proposed Plan of Disgorgement and Opportunity for Comment ("Notice") in connection with this proceeding (see Exchange Act Rel. No. 60160) pursuant to Rule 1103 of the Commission's Rules on Fair Funds and Disgorgement Plans, 17 C.F.R. 201.1103. No comments were received by the Commission in response to the Notice and on August 25, 2009, the Commission approved the Plan (see Exchange Act Rel. No. 60568).

The Plan provides that the Commission will arrange for distribution of the Disgorgement Fund when a validated payment file listing the payees with the identification information required to make a distribution has been received and accepted. The validated payment file has been received and accepted for the disbursement of $584,028.55.[1]

[1] By Order Directing Disbursement of Disgorgement Fund dated May 24, 2010, the Commission ordered the disbursement of $2,891,887.33 (see Exchange Act Rel. No. 62162). By Order Directing Disbursement of Disgorgement Fund dated November 30, 2010, the Commission ordered the disbursement of $457,821.82 (see Exchange Act Rel. No. 63399).

Accordingly, it is ORDERED that the Commission staff shall disburse the Disgorgement Fund in the amount stated in the validated payment file of $584,028.55 as provided in the Plan.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Chairman Schapiro
Commissioner Aguilar
Commissioner Paredes
not participating

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 64079 / March 14, 2011

INVESTMENT ADVISERS ACT OF 1940
Rel. No. 3174 / March 14, 2011

INVESTMENT COMPANY ACT OF 1940
Rel. No. 29599 / March 14, 2011

Admin. Proc. File No. 3-12978

In the Matter of ROBERT L. BURNS c/o Greer 20 Hilltop Road Chestnut Hill, MA 02467	ORDER GRANTING PARTIAL PROTECTIVE ORDER

On February 9, 2011, Robert L. Burns submitted a petition for review of an administrative law judge's initial decision together with a "Statement of Financial Condition," both of which contain personal financial information that he requests be protected from public disclosure ("Confidential Information"). The Division of Enforcement has not responded to Burns's request for a protective order.

Under Rule of Practice 322, any party "may file a motion requesting a protective order to limit from disclosure to other parties or to the public documents or testimony that contain confidential information."[1] That rule further provides that "[a] motion for a protective order shall be granted only upon a finding that the harm resulting from disclosure would outweigh the benefits of disclosure."[2]

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1 17 C.F.R. § 201.322(a).

2 17 C.F.R. § 201.322(b).

The documents that Burns submitted contain sensitive information and, at this stage in the proceeding, the harm resulting from complete disclosure appears to outweigh the benefits. However, we have determined that disclosure of certain information included in the record will be necessary to the resolution of the issues before us.

Accordingly, IT IS ORDERED that:

1. Except as otherwise provided in this Order, the Confidential Information shall be disclosed only to the parties to this action, their counsel, the Commission, any staff advising the Commission in its deliberative processes with respect to this proceeding, and in the event of an appeal of the Commission's determination, any staff acting for the Commission in connection with that appeal.

2. All persons who receive access to the Confidential Information shall keep it confidential and, except as provided in this Order, shall not divulge the Confidential Information to any person.

3. No person to whom the Confidential Information is disclosed shall make any copies or otherwise use such Confidential Information, except in connection with this proceeding or any appeal thereof.

4. The Office of the Secretary shall place the Confidential Information in sealed envelopes or other sealed containers marked with the title of this action, identifying each document, and marked "CONFIDENTIAL."

5. The requirements of sealing and confidentiality shall not apply to any reference to the existence of the Confidential Information or to citation of particular information contained therein in testimony, oral argument, briefs, opinions, or in any other similar use directly connected with this action or any appeal thereof.

6. The Commission expressly reserves the authority to reach a different conclusion regarding the confidentiality of the Confidential Information covered by this Order at any time before it determines the issues raised in the proceeding.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Chairman Schapiro not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 3175 / March 14, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14296

In the Matter of JSK Associates, Inc., Jerome S. Keenan, and Paul Dos Santos Respondents.	ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTIONS 203(e), 203(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") against JSK Associates, Inc. ("JSK"), Jerome S. Keenan ("Keenan") and Paul Dos Santos ("Dos Santos") (collectively, "Respondents").

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the "Offers") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and over the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondents' Offers, the Commission finds that:

A. SUMMARY

1. This matter concerns the failure by JSK, Keenan and Dos Santos to disclose to their advisory clients the financial benefits that International Equity Services, Inc. ("IES"), a broker-dealer under common control with JSK, derived from the advisory clients' accounts.

2. In addition, JSK, through IES, engaged in fixed income transactions on a riskless principal basis and failed to provide prior written disclosure to its advisory clients, or obtain consent from those clients, that it would effect the trades on a principal basis. Finally, JSK failed to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder, and failed to establish, maintain and enforce a written code of ethics satisfying the requirements of Rule 204A-1 under the Advisers Act. Keenan and Dos Santos willfully aided and abetted and caused these violations.

B. RESPONDENTS

3. JSK is a New York corporation headquartered in White Plains, New York. JSK has been registered with the Commission as an investment adviser since 1984. JSK has approximately 170 accounts with approximately $29 million of assets under management. JSK has four employees, including Keenan and Dos Santos.

4. Keenan, age 73, is a resident of White Plains, New York, and is the President and Chief Compliance Officer of JSK and Vice President and Chief Compliance Officer of IES. Keenan owns fifty percent of both JSK and IES and is a director of each entity.

5. Dos Santos, age 56, is a resident of Stormville, New York and is the Vice President of JSK and the President and the Financial and Operations Principal of IES. Dos Santos owns fifty percent of both JSK and IES and is a director of each entity.

C. RELEVANT ENTITY

6. IES is a New York corporation headquartered in White Plains, New York. IES has been registered with the Commission as a broker-dealer since 2000. IES serves as the introducing broker to JSK's clients. IES has four employees, including Keenan and Dos Santos.

D. BACKGROUND

7. JSK provides non-discretionary investment advisory and financial planning services to individuals and entities. Keenan and Dos Santos make investment recommendations to clients and, upon the clients' consent, IES executes the transactions. JSK charges clients a standard fee based on assets under management. JSK executes its clients' securities transactions through IES. IES has clearing and custodial arrangements with Southwest Securities, Inc. ("SWS").

E. THE VIOLATIVE CONDUCT

8. Between January 1, 2006 and December 31, 2009, JSK failed to inform advisory clients about financial benefits that its affiliated broker-dealer IES derived in the form of payments received as a result of the cash holdings in advisory client accounts. During the same period, JSK, through IES, engaged in hundreds of fixed-income transactions on a riskless principal basis with advisory clients without providing prior written disclosure to, or obtaining consent from, clients. Finally, from at least July 2007 through July 7, 2009, JSK failed to adopt written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act, and failed to establish, maintain and enforce an adequate written code of ethics.

Undisclosed Clearing Firm Payments

9. IES received payments for JSK's advisory clients' credit balances and uninvested cash maintained in their IES brokerage accounts, which JSK failed to adequately disclose to its clients. Pursuant to the clearing arrangements between IES and SWS, IES was entitled to receive payments from SWS equal to 0.25% of (a) the average credit balances for JSK's advisory client accounts that were invested in the AMR Money Market Fund; and (b) the average balance of uninvested cash in the JSK's advisory client's brokerage accounts. IES received $60,350 from SWS between January 1, 2006 and December 31, 2009.

10. While JSK disclosed that IES might receive forms of compensation such as "clearing and processing fee's [sic], trailer commissions, and other revenues which Broker Dealers normally receive in the course of doing business," JSK failed to disclose in its Form ADV (or otherwise) that IES would receive compensation based on JSK's advisory clients' uninvested cash and certain money market fund balances.

Undisclosed Riskless Principal Transactions

11. JSK, through IES, engaged in hundreds of fixed-income transactions involving mark-ups and mark-downs with advisory clients without providing prior written disclosure that it would effect the trades on a principal basis to, or obtaining consent from, clients.

12. However, JSK did not disclose in its Form ADV (or otherwise) that JSK, or IES, would effect principal trades for advisory clients.

Failure to Adopt and Implement Written Policies and Procedures Reasonably Designed to Prevent Violations of the Advisers Act and the Rules thereunder

13. JSK's Operational Procedures Manual, prior to its revision in July 2009, was primarily focused on broker-dealer activities and did not address the Advisers Act except in the final "Code of Ethics" section and, for example, did not discuss JSK's Form ADV or the types of potential conflicts of interest specific to an investment adviser.

14. JSK did not adopt written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act and did not review its policies and procedures for approximately two years to determine their adequacy and the effectiveness of their implementation, including whether changes in the Advisers Act or applicable regulations might require changes to its policies or procedures.

Failure to Establish, Maintain and Enforce a Written Code of Ethics

15. JSK's Code of Ethics in effect from at least July 2007 until July 2009 did not contain all of the elements required by Section 204 of the Advisers Act and Rule 204A-1 thereunder. For example, the Code of Ethics did not include a provision requiring that an "access person" submit an initial holdings report concerning information such as each reportable security in which such person had any direct or indirect beneficial ownership.

16. Further, JSK did not enforce all the policies and procedures in its July 2009 revised Code of Ethics. For example, JSK did not require all "access persons" to provide JSK with duplicate brokerage account statements, as provided in its revised Code.

F. VIOLATIONS

17. As a result of the conduct described above, JSK, Keenan and Dos Santos willfully violated Section 206(2) of the Advisers Act which prohibits an investment adviser from engaging in any transaction, practice, or course of business that operates as a fraud or deceit upon any client or prospective client.

18. As a result of the conduct described above, JSK willfully violated Section 206(3) of the Advisers Act, which prohibits an investment adviser from executing securities transactions with a client on a principal basis without disclosing to such client in writing, before the completion of such transaction, the capacity in which it is acting and obtaining the consent of the client to such transaction.

19. As a result of the conduct described above, Keenan and Dos Santos willfully aided and abetted and caused JSK's violations of Section 206(3) of the Advisers Act.

20. As a result of the conduct described above, JSK willfully violated Sections 204, 204A, 206(4) and 207 of the Advisers Act and Rules 204-1(a)(2), 204A-1 and 206(4)-7 thereunder, which prohibit any person from making an untrue statement in a report filed with the Commission and require that an adviser file periodic amendment of Form ADV; require that an investment adviser adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder; and require that an investment adviser establish, maintain and enforce a written code of ethics.

21. As a result of the conduct described above, Keenan and Dos Santos willfully aided and abetted and caused JSK's violations of Sections 204, 204A, 206(4) and 207 of the Advisers Act and Rules 204-1(a)(2), 204A-1 and 206(4)-7 thereunder.

Respondents' Remedial Efforts

In determining to accept the Offers, the Commission considered remedial acts promptly undertaken by Respondents and cooperation afforded the Commission staff.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondents' Offers.

Accordingly, pursuant to Sections 203(e), 203(f) and 203(k) of the Advisers Act, it is hereby ORDERED that:

A. Pursuant to Section 203(k) of the Advisers Act, JSK shall cease and desist from committing or causing any violations and any future violations of Sections 204, 204A, 206(2), 206(3), 206(4) and 207 of the Advisers Act and Rules 204-1(a)(2), 204A-1 and 206(4)-7 promulgated thereunder.

B. Pursuant to Section 203(e) of the Advisers Act, JSK is censured.

C. JSK shall, within ten days of the entry of this Order, pay a civil money penalty in the amount of $60,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Such payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies JSK as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Amelia A. Cottrell, Assistant Director, and to Robert J. Keyes, Associate Regional Director, Securities and Exchange Commission, 3 World Financial Center, Room 400, New York, New York 10281-1022.

D. Pursuant to Section 203(k) of the Advisers Act, Keenan and Dos Santos shall cease and desist from committing or causing any violations and any future violations of Sections 204, 204A, 206(2), 206(3), 206(4) and 207 of the Advisers Act and Rules 204-1(a)(2), 204A-1 and 206(4)-7 promulgated thereunder.

E. Pursuant to Section 203(f) of the Advisers Act, Keenan and Dos Santos are censured.

F. Keenan and Dos Santos each shall, within ten days of the entry of this Order, pay a civil money penalty in the amount of $10,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Such payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies such Respondent as a respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Amelia A. Cottrell, Assistant Director, and to Robert J. Keyes, Associate Regional Director, Securities and Exchange Commission, 3 World Financial Center, Room 400, New York, New York 10281-1022.

G. Respondents shall, within ten days of the entry of this Order, pay disgorgement, on a joint and several basis, of $60,350 and prejudgment interest of $3,805 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. Payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies such Respondent as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Amelia A. Cottrell, Assistant Director, and to Robert J. Keyes, Associate Regional Director, Securities and Exchange Commission, 3 World Financial Center, Room 400, New York, New York 10281-1022.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR PART 240

[Release No. 34-64087; File No. S7-10-11]

RIN 3235-AK98

BENEFICIAL OWNERSHIP REPORTING REQUIREMENTS AND SECURITY-BASED SWAPS

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: To preserve the application of our existing beneficial ownership rules to persons who purchase or sell security-based swaps after the effective date of new Section 13(o) of the Securities Exchange Act of 1934, we are proposing to readopt without change the relevant portions of Rules 13d-3 and 16a-1. The proposals are intended to clarify that following the July 16, 2011 statutory effective date of Section 13(o), which was added by Section 766 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), persons who purchase or sell security-based swaps will remain within the scope of these rules to the same extent as they are now.

DATES: Comments should be received on or before April 15, 2011.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml);
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-10-11 on the subject line; or
- Use the Federal Rulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-10-11. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/proposed.shtml). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Nicholas Panos, Senior Special Counsel, at (202) 551-3440, or Anne Krauskopf, Senior Special Counsel, at (202) 551-3500, Division of Corporation Finance, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-3628.

SUPPLEMENTARY INFORMATION: We are proposing to readopt without change portions of Rules 13d-3[1] and 16a-1[2] under the Securities Exchange Act of 1934 ("Exchange Act").[3]

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1 17 CFR 240.13d-3.

2 17 CFR 240.16a-1.

3 15 U.S.C. 78a et seq.

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I. OVERVIEW AND BACKGROUND

A. Overview

Section 766 of the Dodd-Frank Act amends the Exchange Act by adding Section 13(o), which provides that "[f]or purposes of this section and section 16, a person shall be deemed to acquire beneficial ownership of an equity security based on the purchase or sale of a security-based swap, only to the extent that the Commission, by rule, determines after consultation with the prudential regulators and the Secretary of the Treasury, that the purchase or sale of the security-based swap, or class of security-based swap, provides incidents of ownership comparable to direct ownership of the equity security, and that it is necessary to achieve the purposes of this section that the purchase or sale of the security-based swaps, or class of security-based swap, be deemed the acquisition of beneficial ownership of the equity security." Section 766 and Section 13(o)[4] become effective on July 16, 2011.[5]

The reason for this rulemaking, as discussed in more detail below, is to preserve the existing scope of our rules relating to beneficial ownership after Section 766 of the Dodd-Frank Act becomes effective. Absent rulemaking under Section 13(o), Section 766 may be interpreted to render the beneficial ownership determinations made under Rule 13d-3 inapplicable to a person who purchases or sells a security-based swap.[6] In that circumstance,

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4 Pub. L. No. 111–203, 124 Stat. 1797.

5 See Section 774 of the Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat 1376 (2010), which states that Section 766 becomes effective "360 Days after the date of enactment."

6 A "security-based swap" is defined in Section 3(a)(68) [15 U.S.C. 78c(a)(68), added by Section 761(a) of the Dodd-Frank Act]. Section 712(d) of the Dodd-Frank Act provides that the Commission and the Commodity Futures Trading Commission ("CFTC"), in consultation with the Board of Governors of

it could become possible for an investor to use a security-based swap to accumulate an influential or control position in a public company without public disclosure. Similarly, a person who holds a security-based swap that confers beneficial ownership of the referenced equity securities under Section 13 and existing Rule 13d-3, or otherwise conveys such beneficial ownership through an understanding or relationship based upon the purchase or sale of the security-based swap, may no longer be considered a ten percent holder subject to Section 16 of the Exchange Act.[7] Further, an insider may no longer be subject to Section 16 reporting and short-swing profit recovery through transactions in security-based swaps that confer a right to receive either the underlying equity securities or cash. In addition, private parties may have difficulty making, or exercising private rights of action to seek to have made, determinations of beneficial ownership arising from the purchase or sale of a security-based swap.

To preserve the application of our existing beneficial ownership rules to persons who purchase or sell security-based swaps after the effective date of Section 13(o), we are proposing to readopt without change the relevant portions of Rules 13d-3 and 16a-1. These

the Federal Reserve System ("Federal Reserve"), shall jointly further define, among others, the terms "swap," "security-based swap," and "security-based swap agreement." These terms are defined in Sections 721 and 761 of the Dodd-Frank Act. The definitions of the terms "swap," "security-based swap," and "security-based swap agreement," and regulations regarding mixed swaps also are expected to be the subject of a separate rulemaking by the Commission and the CFTC. In addition, Section 721(c) and 761(b) of the Dodd-Frank Act provide the CFTC and the Commission with the authority to define the terms "swap" and "security-based swap," among other terms, to include transactions that have been structured to evade the requirements of subtitles A and B of Title VII, respectively, of the Dodd-Frank Act. To assist the Commission and CFTC in further defining the terms specified above, the Commission and the CFTC sought comment from interested parties. See Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act, Release No. 34-62717 (Aug. 13, 2010) [75 FR 51429] (advance joint notice of proposed rulemaking regarding definitions).

7 15 U.S.C. 78p.

proposals are limited to the continued application of these rules by the Commission on the same basis that they currently apply to persons who use security-based swaps.[8] While these proposals are only intended to preserve the existing application of the beneficial ownership rules as they relate to security-based swaps, our staff is engaged in a separate project to develop proposals to modernize reporting under Exchange Act Sections 13(d)[9] and 13(g).[10]

B. Sections 13(d) and 13(g) and Rule 13d-3

Sections 13(d) and 13(g) require a person who is the beneficial owner of more than five percent of certain equity securities[11] to disclose information relating to such beneficial ownership. While these statutory sections do not define the term "beneficial owner," the Commission has adopted rules that determine the circumstances under which a person is or may be deemed to be a beneficial owner. In order to provide objective standards for determining when a person is or may be deemed to be a beneficial owner subject to Section 13(d), the Commission adopted Exchange Act Rule 13d-3.[12] Application of the standards

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8 In addition, the proposed readoption of the relevant portions of existing Rules 13d-3 and 16a-1(a) is neither intended nor expected to change any existing administrative or judicial application or interpretation of the rules.

9 15 U.S.C. 78m(d).

10 15 U.S.C. 78m(g).

11 Section 13(d)(1) applies to any equity security of a class that is registered pursuant to Section 12 of the Exchange Act, any equity security issued by a "native corporation" pursuant to Section 37(d)(6) of the Alaska Native Claims Settlement Act, and any equity security described in Exchange Act Rule 13d-1(i) [17 CFR 240.13d-1(i)]. Rule 13d-1(i) explains that for purposes of Regulation 13D-G, "the term 'equity security' means any equity security of a class which is registered pursuant to section 12 of that Act, or any equity security of any insurance company which would have been required to be so registered except for the exemption contained in section 12(g)(2)(G) of the Act, or any equity security issued by a closed-end investment company registered under the Investment Company Act of 1940; Provided, Such term shall not include securities of a class of non-voting securities."

12 Adoption of Beneficial Ownership Disclosure Requirements, Release No. 34-13291 (Feb. 24, 1977) [42 FR 12342].

within Rule 13d-3 allows for case-by-case determinations as to whether a person is or becomes a beneficial owner, including a person who uses a security-based swap.

Under Rule 13d-3(a), a beneficial owner includes any person who directly or indirectly has or shares voting power and/or investment power over an equity security. Voting power includes "the power to vote, or to direct the voting of, such security" and investment power includes "the power to dispose, or to direct the disposition, of such security." Identifying each person who possesses voting or investment power requires an analysis of all of the relevant facts and circumstances. Rule 13d-3(a) provides that a beneficial owner "includes any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, has or shares" voting power and/or investment power over an equity security. The rule, by its terms, provides that a person may become a beneficial owner through means other than an acquisition of securities or formal agreement, and that a person may be a beneficial owner even if that person shares voting or investment power with another person and is only able to indirectly exercise such power by directing the voting or disposition of the subject security.[13]

Rule 13d-3(b) provides that "[a]ny person who, directly or indirectly, creates or uses a trust, proxy, power of attorney, pooling arrangement or any other contract, arrangement, or device with the purpose [or] effect of divesting such person of beneficial ownership of a security or preventing the vesting of such beneficial ownership as part of a plan or scheme to

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13 The Commission, in recognition of the breadth of this provision, has emphasized its necessity in order "to obtain disclosure from all those persons who have the ability to change or influence control." Filing and Disclosure Requirements Relating to Beneficial Ownership, Release No. 34-14692 (Apr. 21, 1978) [43 FR 18484].

evade the reporting requirements of section 13(d) or (g) of the Act shall be deemed for purposes of such sections to be the beneficial owner of such security." In contrast to Rule 13d-3(a), application of Rule 13d-3(b) may result in a beneficial ownership determination even if a person does not hold voting and/or investment power.[14]

Under Rule 13d-3(d)(1), a person is deemed a beneficial owner if the person has the right to acquire beneficial ownership, as defined in Rule 13d-3(a), at any time within 60 days. The right includes, but is not limited to, any right to acquire through the exercise of an option, warrant or right, conversion of a convertible security, or power to revoke a trust or similar agreement. Rule 13d-3(d)(1) further provides that if a person acquires an option, warrant, right, convertible security or power to revoke with the purpose or with the effect of changing or influencing control of the issuer, or as a participant in a transaction having such purpose or effect, then the person is deemed to be a beneficial owner immediately, regardless of when the option, right, convertible security or power to revoke is exercisable or convertible.

If beneficial ownership, as determined in accordance with Rules 13d-3(a), 13d-3(b) and 13d-3(d)(1), exceeds the designated thresholds, beneficial owners are required to provide specified disclosures. The disclosures are intended to be required of persons who have the potential to influence or gain control of the issuer.[15] Specifically, Section 13(d) and the rules

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14 See Example 8 from Release No. 34-13291 for an illustration of how Rule 13d-3(b) can apply to a grant of an irrevocable proxy.

15 S. Rep. No. 550, at 7 (1967); H.R. Rep. No. 1711, at 8 (1968); Full Disclosure of Corporate Equity Ownership and in Corporate Takeover Bids, Hearings on S. 510 before the S. Banking and Currency Comm., 90th Cong. 16 (1967) ("The bill now before you has a much closer relationship to existing provisions of the Exchange Act regulating solicitation of proxies, since acquisitions of blocks of voting securities are typically alternatives to proxy solicitations, as methods of capturing or preserving

thereunder require that a person file with the Commission, within ten days after acquiring, directly or indirectly, beneficial ownership of more than five percent of a class of equity securities, a disclosure statement on Schedule 13D,[16] subject to certain exceptions.[17] Section 13(g) and the rules thereunder enable certain persons who are the beneficial owners of more than five percent of a class of certain equity securities to instead file a short form Schedule 13G,[18] assuming certain conditions have been met.[19] These statutory provisions and corresponding rules also impose obligations on beneficial owners to report changes in the information filed.

The beneficial ownership disclosure requirements of Schedules 13D and 13G were designed to provide disclosures to security holders regarding persons holding significant positions in public companies, such as the identity of the beneficial owners, the amount of beneficial ownership, the existence of a beneficial owner group, and in the case of persons who file a Schedule 13D, plans or proposals regarding the issuer. The disclosures made in

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control."); Takeover Bids, Hearings on H.R. 14475 and S.510 before the Subcomm. on Commerce and Fin. of the H. Comm. on Interstate and Foreign Commerce, 90th Cong. (1968).

16 17 CFR 240.13d-101.

17 See Section 13(d)(6) and Rule 13d-1(b)-(d).

18 17 CFR 240.13d-102.

19 See Amendments to Beneficial Ownership Reporting Requirements, Release No. 34-39538 (Jan. 12, 1998) [63 FR 2854] for a description of the types of persons eligible to file a Schedule 13G. The investors eligible to report beneficial ownership on Schedule 13G are commonly referred to as qualified institutional investors under Rule 13d-1(b), passive investors under Rule 13d-1(c), and exempt investors under Rule 13d-1(d). Unlike Section 13(d), Section 13(g) applies regardless of whether beneficial ownership has been "acquir[ed]" within the meaning of Section 13(d) or is viewed as not having been acquired for purposes of Section 13(d). For example, persons who obtain all their securities before the issuer registers the subject securities under the Exchange Act are not subject to Section 13(d) and persons who acquire not more than two percent of a class of subject securities within a 12-month period are exempt from Section 13(d) by Section 13(d)(6)(B), but in both cases are subject to Section 13(g).

Schedules 13D and 13G have been viewed as contributing to the information available to help investors make fully informed investment decisions with respect to their securities.[20] An additional regulatory objective served by these disclosures is to provide management of the issuer with information to "appropriately protect the interests of its security holders."[21] In enacting the original Section 13(d) legislation, Congress made clear that its new regulatory initiative was intended to avoid "tipping the balance of regulation either in favor of management or in favor of the person [potentially] making the takeover bid."[22] In addition to providing information to issuers and security holders, Section 13(d) was adopted with a view toward alerting "the marketplace to every large, rapid aggregation or accumulation of securities, regardless of technique employed, which might represent a potential shift in

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20 See Computer Network Corp. v. Spohler [1982 Transfer Binder] Fed Sec. L. Rep (CCH) ¶ 98,623 at 93,087 (D.D.C. March 23, 1982). See also, San Francisco Real Estate Investors v. REIT of America, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,874, at 94,557 (D. Mass. Nov. 19, 1982), aff'd in part, rev'd in part 701 F.2d 1000 (1st Cir. 1983). The Commission also has recognized that Section 13(d) was enacted primarily to provide "adequate disclosure to stockholders in connection with any substantial acquisition of securities within a relatively short time." Adoption of Beneficial Ownership Disclosure Requirements, Release No. 34-13291, (Feb. 24, 1977) [42 FR 12342] citing S. Rep. No. 550, at 7 (1967).

21 H.R. Rep. No. 1655, at 3 (1970); see, e.g., Additional Consumer Protection in Corporate Takeovers and Increasing the Sec. Act Exemptions for Small Businessmen, Hearing Before the Sec. Subcomm. of the S. Banking and Currency Comm. on S. 336 and S. 343, 91st Cong. (1970). See also Bath Indus. v. Blot, 427 F.2d 97, 113 (7th Cir. 1970). In addition, disclosures made in compliance with Sections 13(d) and 13(g) also provide issuers that file registration statements, annual reports, proxy statements and other disclosure documents with the information they use to disclose all beneficial owners of more than five percent of certain classes of the issuer's equity securities as required by Item 403 of Regulation S-K. [17 CFR 229.403]. See generally H.R. Rep. No. 1655.

22 H.R. Rep. No. 1711, at 4 (1968); S. Rep. No. 550, at 3 (1968). Both the House and Senate reports emphasized that Section 13(d) was enacted "to require full and fair disclosure for the benefit of investors while at the same time providing the offeror and management equal opportunity to fairly present their case."

corporate control."[23] On the basis of the information disclosed, the market would "value the shares accordingly"[24] due to the increased prospects for price discovery.[25]

C. Application of the Section 13 Beneficial Ownership Regulatory Provisions to Persons Who Purchase or Sell Security-Based Swaps

As noted above, the term "security-based swap" is defined in Section 3(a)(68) of the Exchange Act.[26] Under our existing rules, holders of security-based swaps may be subject to beneficial ownership reporting. As explained in more detail below, in cases where a security-based swap confers voting and/or investment power (or a person otherwise acquires such power based on the purchase or sale of a security-based swap), grants a right to acquire an equity security, or is used with the purpose or effect of divesting or preventing the vesting

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23 GAF Corp. v. Milstein, 453 F.2d 709, 717 (2d. Cir. 1971), cert. denied, 406 U.S. 910 (1972), cited by the Commission at footnote 16 in the following administrative proceeding: In the Matter of Harvey Katz, Release No. 34-20893 (April 25, 1984). A measure of what Congress considered to be large and rapid acquisitions is Section 13(d)(6)(B), which exempts acquisitions of two percent or less in the preceding twelve months.

24 General Aircraft Corp. v. Lampert, 556 F.2d 90, 94 (1st Cir. 1977); see also S. Rep. No. 550, at 3 ("But where no information is available about the persons seeking control, or their plans, the shareholder is forced to make a decision on the basis of a market price which reflects an evaluation of the company based on the assumption that the present management and its policies will continue. The persons seeking control, however, have information about themselves and about their plans which, if known to investors, might substantially change the assumptions on which the market price is based.").

25 Takeover Bids, Hearings on 14475 and S. 510 before the Subcomm. on Commerce and Fin. of the H. Comm. on Interstate and Foreign Commerce, 90th Cong. 12 (1968) (statement of Hon. Manuel F. Cohen, Chairman, U.S. Securities and Exchange Commission, "But I might ask, how can an investor evaluate the adequacy of the price if he cannot assess the possible impact of a change in control? Certainly without such information he cannot judge its adequacy by the current or recent market price. That price presumably reflects the assumption that the company's present business, control and management will continue. If that assumption is changed, is it not likely that the market price might change?").

26 See note 6 above.

of beneficial ownership as part of a plan or scheme to evade the reporting requirements, our existing regulatory regime may require the reporting of beneficial ownership.[27]

First, under existing Rule 13d-3(a), to the extent a security-based swap provides a person, directly or indirectly, with exclusive or shared voting and/or investment power over the equity security through a contractual term of the security-based swap or otherwise, the person becomes a beneficial owner of that equity security. Under Rule 13d-3(a), a person may become a beneficial owner even though the person has not acquired the equity security.[28]

Second, existing Rule 13d-3(b) generally provides that a person is deemed to be a beneficial owner if that person uses any contract, arrangement, or device as part of a plan or scheme to evade the beneficial ownership reporting requirements. To the extent a security-based swap is used with the purpose or effect of divesting a person of beneficial ownership or preventing the vesting of beneficial ownership as part of a plan or scheme to evade Sections 13(d) or 13(g), the security-based swap may be viewed as a contract, arrangement or device

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27 Except as provided below regarding Section 16, this release does not address whether, or under what circumstances, an agreement, contract, or transaction that is labeled a security-based swap (including one which confers voting and/or investment power, grants a right to acquire one or more equity securities, or is used with the purpose or effect of divesting or preventing the vesting of beneficial ownership as part of a plan or scheme to evade the beneficial ownership reporting requirements) would be a purchase or sale of the underlying securit(ies) and treated as such for purposes of the federal securities laws, instead of a security-based swap. In this regard, among other things, the definition of "swap" (and therefore the definition of "security-based swap") specifically excludes the purchase or sale of one or more securities on a fixed or contingent basis, unless the agreement, contract, or transaction predicates the purchase or sale on the occurrence of a bona fide contingency that might reasonably be expected to affect or be affected by the creditworthiness of a party other than a party to the agreement, contract, or transaction. See Sections 1a(47)(B)(v) and (vi) of the Commodity Exchange Act, 7 U.S.C. 1a(47)(B)(v) and (vi).

28 Exchange Act Section 13(d)(1) applies after a person directly or indirectly acquires beneficial ownership, regardless of whether the person has made an acquisition of the equity securities.

within the meaning of those terms as used in Rule 13d-3(b). A person using a security-based swap, therefore, may be deemed a beneficial owner under Rule 13d-3(b) in this context.

Finally, under existing Rule 13d-3(d)(1), a person is deemed a beneficial owner of an equity security if the person has a right to acquire the equity security within 60 days or holds the right with the purpose or effect of changing or influencing control of the issuer of the security for which the right is exercisable, regardless of whether the right to acquire originates in a security-based swap or an understanding in connection with a security-based swap. This type of right to acquire an equity security, if obtained through a security-based swap, is treated the same as any other right to acquire an equity security. Acquisition of such a right, regardless of its origin, results in a person being deemed a beneficial owner under Rule 13d-3(d)(1).

D. Section 16 and Rules 16a-1(a)(1) and 16a-1(a)(2)

Section 16 was designed both to provide the public with information about securities transactions and holdings of every person who is the beneficial owner of more than ten percent of a class of equity security registered under Exchange Act Section 12[29] ("ten percent holder"), and each officer and director (collectively, "insiders") of the issuer of such a security, and to deter such insiders from profiting from short-term trading in issuer securities while in possession of material, non-public information. Upon becoming an insider, or upon Section 12 registration of the class of equity security, Section 16(a)[30] requires an insider to file an initial report with the Commission disclosing his or her beneficial ownership of all

29 15 U.S.C. 78l.

30 15 U.S.C. 78p(a).

equity securities of the issuer.[31] Section 16(a) also requires insiders to report subsequent changes in such ownership.[32] To prevent misuse of inside information by insiders, Section 16(b)[33] provides the issuer (or shareholders suing on the issuer's behalf) a strict liability private right of action to recover any profit realized by an insider from any purchase and sale (or sale and purchase) of any equity security of the issuer within a period of less than six months.[34]

As applied to ten percent holders, Congress intended Section 16 to reach persons presumed to have access to information because they can influence or control the issuer as a result of their equity ownership.[35] Because Section 13(d) specifically addresses these relationships, the Commission adopted Rule 16a-1(a)(1) to define ten percent holders under Section 16 as persons deemed ten percent beneficial owners under Section 13(d) and the rules thereunder.[36] The Section 13(d) analysis, such as counting beneficial ownership of those derivative securities exercisable or convertible within 60 days,[37] is imported into the ten percent holder determination for Section 16 purposes. The application of Rule 16a-1(a)(1) is straightforward; if a person is a ten percent beneficial owner as determined

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31 Insiders file these reports on Form 3 [17 CFR 249.103].

32 Insiders file transaction reports on Form 4 [17 CFR 249.104] and Form 5 [17 CFR 249.105].

33 15 U.S.C. 78p(b).

34 In addition, insiders are subject to the short sale prohibitions of Section 16(c) [15 U.S.C. 78p(c)].

35 <u>See</u> S. Rep. No. 1455, at 55, 68 (1934); <u>See also</u> S. Rep. No. 792, at 20-1 (1934); S. Rep. No. 379, at 21-2 (1963).

36 Ownership Reports and Trading By Officers, Directors and Principal Security Holders, Release No. 34-28869 (Feb. 21, 1991) [56 FR 7242].

37 Rule 13d-3(d).

pursuant to Section 13(d) and the rules thereunder, the person is deemed a ten percent holder under Section 16.[38]

For purposes of Section 16(a) reporting obligations and Section 16(b) short-swing profit recovery, Rule 16a-1(a)(2) uses a different definition of "beneficial owner." Once a person is subject to Section 16, for reporting and profit recovery purposes, Rule 16a-1(a)(2) defines "beneficial owner" based on whether the person has or shares a direct or indirect pecuniary interest in the securities. A "pecuniary interest" in any class of equity securities means "the opportunity, directly or indirectly, to profit or share in any profit derived from a transaction in the subject securities."[39] An "indirect pecuniary interest" in any class of equity securities includes, but is not limited to "a person's right to acquire equity securities through the exercise or conversion of any derivative security, whether or not presently exercisable."[40] "Derivative securities" are "any option, warrant, convertible security, stock appreciation right, or similar right with an exercise or conversion privilege at a price related to an equity security, or similar securities with a value derived from the value of an equity security, but shall not include [...] rights with an exercise or conversion privilege at a price that is not

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38 For example, the Commission applied an analysis derived from Rule 13d-3(d)(1) in publishing its views regarding when equity securities underlying a security future that requires physical settlement should be counted for purposes of determining whether the purchaser of the security future is subject to Section 16 as a ten percent holder by operation of Rule 16a-1(a)(1). Commission Guidance on the Application Certain Provisions of the Securities Exchange Act of 1934, and Rules Thereunder to Trading in Security Futures Products, Release No. 34-46101 (June 21, 2002) [67 FR 43234] ("Futures Interpretive Release") at Q 7.

39 Rule 16a-1(a)(2)(i).

40 Rule 16a-1(a)(2)(ii)(F).

fixed."[41] Equity securities of an issuer are "any equity security or derivative security relating to an issuer, whether or not issued by that issuer."[42]

This framework recognizes that holding derivative securities is functionally equivalent to holding the underlying equity securities for Section 16 purposes because the value of the derivative securities is a function of or related to the value of the underlying equity security.[43] Just as an insider's opportunity to profit begins upon purchasing or selling issuer common stock, the opportunity to profit begins when an insider engages in transactions in derivative securities that provide an opportunity to obtain or dispose of the stock at a fixed price.[44] Establishing or increasing a call equivalent position[45] (or liquidating or decreasing a put equivalent position)[46] is deemed a purchase of the underlying security,

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41 Rule 16a-1(c)(6).

42 Rule 16a-1(d). Further, Rule 16a-4(a) [17 CFR 240.16a-4(a)] provides that for purposes of Section 16, both derivative securities and the underlying securities to which they relate are deemed to the be the same class of equity securities, except that the acquisition or disposition of any derivative security must be separately reported.

43 For example, the Futures Interpretive Release, at Q&A Nos. 8-13, explains the status of a security future as a derivative security for purposes of Section 16(a) reporting and Section 16(b) short-swing profit recovery.

44 Ownership Reports and Trading By Officers, Directors and Principal Security Holders, Release No. 34-28869, at Section III.A (Feb. 21, 1991) [56 FR 7242].

45 Rule 16a-1(b) provides that a "call equivalent position" is "a derivative security position that increases in value as the value of the underlying equity security increases, including, but not limited to, a long convertible security, a long call option, and a short put option position."

46 Rule 16a-1(h) provides that a "put equivalent position" is "a derivative security position that increases in value as the value of the underlying equity decreases, including, but not limited to, a long put option and a short call option."

and establishing or increasing a put equivalent position (or liquidating or decreasing a call equivalent position) is deemed a sale of the underlying security.[47]

Rule 16a-1(a)(2) and the related rules described above recognize the functional equivalence of derivative securities and the underlying equity securities by providing that transactions in derivative securities are reportable, and matchable with transactions in other derivative securities and in the underlying equity.[48] For example, short-swing profits obtained by buying call options and selling the underlying stock, or buying the underlying stock and buying put options, are recoverable. This functional equivalence extends to all fixed-price derivative securities, whether issued by the issuer or a third party, and whether the form of settlement is cash or stock.[49]

E. Application of the Section 16 Beneficial Ownership Regulatory Provisions to Holdings and Transactions in Security-Based Swaps

As described above, solely for purposes of determining who is subject to Section 16 as a ten percent holder, Rule 16a-1(a)(1) uses the beneficial ownership tests applied under

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47 Rule 16b-6(a).

48 Rule 16b-6(b) generally exempts from Section 16(b) short-swing profit recovery the exercise or conversion of a fixed-price derivative security, provided that it is not out-of-the-money. Rule 16b-6(c) provides guidance for determining short-swing profit recoverable from transactions involving the purchase and sale or sale and purchase of derivative and other securities.

49 Former Rule 16a-1(c)(3), adopted in Release No. 34-28869, excluded from the definition of "derivative securities" "securities that may be redeemed or exercised only for cash and do not permit the receipt of equity securities in lieu of cash, if the securities either: (i) are awarded pursuant to an employee benefit plan satisfying the provisions of [former] §240.16b-3(c); or (ii) may be redeemed or exercised only upon a fixed date or dates at least six months after award, or upon death, retirement, disability or termination of employment." As a corollary to adopting a broader Rule 16b-3 exemption, the Commission rescinded former Rule 16a-1(c)(3) in 1996, stating that "because the opportunity for profit based on price movement in the underlying stock embodied in a cash-only instrument is the same as for an instrument settled in stock, cash-only instruments should be subject to Section 16 to the same extent as other issuer equity securities." Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Release No. 34-37260, at Section III.A (May 31, 1996) [61 FR 30376].

Section 13(d) and its implementing rules, including Rules 13d-3(a), 13d-3(b), and Rule 13d-3(d)(1). As a result, for example, a person who has the right to acquire securities that would cause the person to own more than ten percent of a class of equity securities through a security-based swap that confers a right to receive equity at settlement or otherwise would be subject to Section 16 as a ten percent holder under existing Rule 16a-1(a)(1). Once a person is subject to Section 16, in order to determine what securities are subject to Section 16(a) reporting and Section 16(b) short-swing profit recovery for any insider (whether an officer, director or ten percent holder), existing Rule 16a-1(a)(2) looks to the insider's pecuniary interest (i.e., opportunity to profit) in the securities. Under existing rules, this concept includes an indirect pecuniary interest in securities underlying fixed-price derivative securities, including security-based swaps, whether settled in cash or stock. Consistent with the derivative securities analysis, the Commission has stated that Section 16 consequences would arise from an equity swap transaction where either party to the transaction is a Section 16 insider with respect to a security to which the swap agreement relates.[50] The Commission has provided interpretive guidance regarding how equity swap transactions should be reported,[51] and adopted transaction code "K" to be used in addition to any other applicable

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50 Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Release No. 34-34514, at Section III.G (Aug. 10, 1994) [59 FR 42449]; Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Release No. 34-37260, at Section IV.H (May 31, 1996) [61 FR 30376].

51 Each report must provide the following information: (1) the date of the transaction; (2) the term; (3) the number of underlying shares; (4) the exercise price (i.e., the dollar value locked in); (5) the non-exempt disposition (acquisition) of shares at the outset of the term; (6) the non-exempt acquisition (disposition) of shares at the end of the term (and at such earlier dates, if any, where events under the equity swap cause a change in a call or put equivalent position); (7) the total number of shares held after the transaction; and (8) any other material terms. Release No. 34-37260, at Section IV.H.

code in reporting equity swap and similar transactions so that they can be easily identified.[52] An equity swap involving a single security, or a narrow-based security index, is a security-based swap as defined in Section 3(a)(68).

II. DISCUSSION OF THE RULE PROPOSALS

New Section 13(o) provides that a person shall be deemed a beneficial owner of an equity security based on the purchase or sale of a security-based swap only to the extent we adopt rules after making certain determinations and consulting with the prudential regulators and the Secretary of the Treasury. The regulatory provisions under which beneficial ownership determinations are currently made with respect to security-based swaps were enacted or adopted before Section 13(o). Accordingly, we are proposing to readopt the relevant portions of Rules 13d-3 and 16a-1 following consultation with the prudential regulators and the Secretary of Treasury to assure that these provisions continue to apply to a person who purchases or sells a security-based swap upon effectiveness of Section 13(o).

The purpose of the proposed rulemaking is solely to preserve the regulatory status quo and provide the certainty and protection that market participants have come to expect with the existing disclosures required by the rules promulgated under Sections 13(d), 13(g) and 16(a). While the use of security-based swaps has not been frequently disclosed in Schedule 13D and 13G filings, we are proposing to readopt Rules 13d-3(a), (b) and (d)(1) and the relevant portions of Rules 16a-1(a)(1) and (a)(2) to further the policy objectives of and foster compliance with these rules upon the effectiveness of Section 13(o).

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52 General Instruction 8 to Form 4 [17 CFR 249.104] (U.S. SEC 1475 (08-07)) and Form 5 [17 CFR 249.105] (U.S. SEC 2270 (1-05)), as amended in Release No. 34-37260, at Section IV.I.

Given the language in Section 13(o), as well as the newly amended Sections 13(d) and 13(g),[53] we are proposing to readopt these rules to remove any doubt that they will continue to allow for the same determinations of beneficial ownership that they do today. Readoption of these rule provisions is intended to ensure that persons who use security-based swaps remain subject to the Section 13(d), Section 13(g) and Section 16 regulatory regimes to the same extent such persons are now. Moreover, the proposed rulemaking is designed to preserve the private right of action provided by Section 16(b) and not disturb any other existing right of action.

Section 13(o) will not render the existing beneficial ownership regulatory provisions inapplicable to persons who obtain beneficial ownership independently from a security-based swap. For example, Rule 13d-3(d)(1) will continue to apply to persons who obtain a right to acquire equity securities if the right does not arise from the purchase or sale of a security-based swap. Rights, options, warrants, or conversion or certain revocation privileges, if acquired or held by persons under circumstances that do not arise from the purchase or sale of a security-based swap, will remain subject to Sections 13(d), 13(g) and 16 and may continue to be treated under Rule 13d-3(d)(1) as the acquisition of beneficial ownership,[54]

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53 See Section 766(b) of the Dodd-Frank Act, which amends Sections 13(d) and 13(g) to provide that a person "becomes or is deemed to become a beneficial owner…upon the purchase or sale of a security-based swap that the Commission may define by rule…."

54 These rights to acquire beneficial ownership are not security-based swaps within the meaning of Section 13(o) because they are purchases and sales of securities. In this regard, the definition of "swap" in Section 721 of the Dodd-Frank Act (and therefore the definition of "security-based swap") excludes purchases and sales of securities, whether on a fixed or contingent basis. Under the Dodd-Frank Act, the term "security" is as defined in the Securities Act and the Exchange Act, which includes options, warrants, and rights to subscribe to or purchase a security and any convertible securities as well as the securities issuable upon exercise or conversion of such securities. In addition, Section 721 of the Dodd-Frank Act excludes from the definition of "swap" any put, call, straddle, option or privilege on any security, certificate of deposit, or group or index of securities, including any interest

and Rules 16a-1(a)(1) and 16a-1(a)(2) will continue to apply. Furthermore, Schedule 13D will continue to require certain disclosures relating to the purchase or sale of security-based swaps notwithstanding Section 13(o).[55]

A. Beneficial Ownership Determinations under Section 13

Section 13(o) provides that a person shall be deemed to acquire beneficial ownership of an equity security based on the purchase or sale of a security-based swap only to the extent that the Commission meets certain conditions and adopts a rule. Although the proposal to readopt Rule 13d-3(a), Rule 13d-3(b), and Rule 13d-3(d)(1) is being made in part pursuant to Section 13(o), we are not proposing any revision to the existing rule text. The proposed rules are the same as the existing rules in all respects.

1. Rule 13d-3(a)

We are proposing to readopt without change Rule 13d-3(a) to address any uncertainty with regard to the application of Rule 13d-3(a) to a person who purchases or sells a security-based swap. If readopted, a determination could continue to be made that a beneficial owner of equity securities includes any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, has or shares voting power and/or

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therein or based on the value thereof, that is subject to the Securities Act of 1933 and the Exchange Act. Furthermore, Section 13(o) does not affect the treatment of "security-based swap agreements" as defined in the Dodd-Frank Act. For example, Section 762(d)(5) of the Dodd-Frank Act clarifies that Section 16 continues to apply to security-based swap agreements.

55 For example, beneficial owners who file a Schedule 13D and use a security-based swap will remain subject to the obligation to comply with Items 6 ("Contracts, Arrangements, Understandings or Relationships With Respect to Securities of the Issuer") and 7 ("Material to be Filed as Exhibits") and provide disclosures relating to the security-based swap depending upon the security-based swap's terms. In addition, beneficial owners who file a Schedule 13G pursuant to Rule 13d-1(b) or otherwise rely upon Rule 13d-1(b) to govern a future reporting obligation may be required to make disclosures on Schedule 13D instead based upon their purchase or sale of a security-based swap. See In the Matter of Perry Corp., Release No. 34-60351 (July 21, 2009).

investment power over the securities based on the purchase or sale of a security-based swap.

Following initial consultation with the prudential regulators[56] and the Secretary of the Treasury, we preliminarily believe that:

- A person's possession of voting and/or investment power in an equity security based on the purchase or sale of a security-based swap is no different from voting or investment power in an equity security that exists independently from a security-based swap when (1) a security-based swap confers, or (2) an arrangement, understanding or relationship based on the purchase or sale of the security-based swap conveys, voting and/or investment power in an equity security. Security-based swaps therefore can provide incidents of ownership comparable to direct ownership of the underlying equity security within the meaning of Section 13(o) to the extent that the security-based swap confers, or an arrangement, understanding or relationship based upon the purchase or sale of the security-based swap conveys, voting and/or investment power in an equity security; and
- Retaining the existing regulatory treatment of security-based swaps in Rule 13d-3(a) is necessary to achieve the purpose of Section 13 so that Sections 13(d) and 13(g) continue to require the filing of beneficial ownership reports that produce disclosure by persons who have the ability or potential to change or influence control of the issuer. In addition, these persons may have the means to acquire significant amounts of equity securities wholly or partly based upon the purchase or sale of a security-

56 Our staff has consulted with the Federal Reserve, the Office of the Comptroller of the Currency, the Farm Credit Administration, the Federal Housing Finance Agency, and the Federal Deposit Insurance Corporation. Our staff also consulted with the CFTC.

based swap. As a result, these persons may have the potential to effect a change of control transaction or preserve or influence control of an issuer. In the case of Schedule 13D filers, these persons would be required to disclose their plans or proposals. Disclosures made in beneficial ownership reports are in the public interest and necessary for the protection of investors because they provide information about certain transactions and related acquisitions of beneficial ownership that: could disclose a potential shift in corporate control; impact the transparency and efficiency of our capital markets; and contribute to price discovery.

2. Rule 13d-3(b)

We are proposing to readopt without change Rule 13d-3(b) to address any uncertainty with regard to the continued application of Rule 13d-3(b) to a person who purchases or sells a security-based swap. Rule 13d-3(b) provides that a person is deemed to be a beneficial owner if that person uses any contract, arrangement, or device as a means to divest or prevent the vesting of beneficial ownership as part of a plan or scheme to evade the beneficial ownership reporting requirements. If readopted, Rule 13d-3(b) would continue to apply to any person that uses a security-based swap as part of a plan or scheme to evade reporting beneficial ownership and thereby accumulate influential or control positions in public issuers without disclosure.

Following initial consultation with the prudential regulators and the Secretary of the Treasury, we preliminarily believe that:

- A person's use of a security-based swap to divest or prevent the vesting of beneficial ownership as part of a plan or scheme to evade the application of Sections 13(d) or

13(g) is no different from a plan or scheme that uses a contract, arrangement or device that exists independently from a security-based swap. In this context, a person would be deemed to have beneficial ownership, and thus incidents of ownership comparable to direct ownership, but for the plan or scheme based in whole or in part upon the purchase or sale of a security-based swap; and

- Retaining the existing regulatory treatment of security-based swaps in Rule 13d-3(b) is necessary to achieve the purpose of Section 13 so that Sections 13(d) and 13(g) continue to require the filing of beneficial ownership reports that produce disclosure by persons who have the ability or potential to change or influence control of the issuer. In addition, these persons may have the means to acquire significant amounts of equity securities based in whole or in part upon the purchase or sale of a security-based swap, and therefore the potential to effect a change of control transaction or preserve or influence control of an issuer. In the case of Schedule 13D filers, these persons would be required to disclose their plans or proposals. Disclosures made in beneficial ownership reports are in the public interest and necessary for the protection of investors because they provide information about certain transactions and related acquisitions of beneficial ownership that: could disclose a potential shift in corporate control; impact the transparency and efficiency of our capital markets; and contribute to price discovery.

3. Rule 13d-3(d)(1)

We are proposing to readopt without change Rule 13d-3(d)(1) to address any uncertainty with regard to the continued application of Rule 13d-3(d)(1) to a person who purchases or sells a security-based swap. Rule 13d-3(d)(1) provides that a person will be deemed to be a beneficial owner of equity securities if the person has the right to acquire beneficial ownership of the securities within 60 days, or at any time if the right is held for the purpose of changing or influencing control. If readopted, Rule 13d-3(d)(1) would continue to apply to any person that obtains such a right based on the purchase or sale of a security-based swap.

The Commission has long recognized the importance of having the beneficial ownership reporting regime account for contingent interests in equity securities arising from investor use of derivatives, such as options, warrants or rights. The Commission adopted Rule 13d-3, the predecessor to Rule 13d-3(d)(1), on August 30, 1968,[57] approximately one month after Congress enacted Section 13(d).[58] The Commission also has treated futures contracts for equity securities the same as options, warrants, or rights for purposes of determining beneficial ownership.[59] When 60 days or less are left until the right to acquire may be exercised, or if a right has been acquired for the purpose or with the effect of changing or influencing control of the issuer of securities, we believe that treating the holder of the right as if the person is a beneficial owner under Rule 13d-3(d)(1) is necessary to

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57 Acquisitions, Tender Offers, and Solicitations, Release No 34-8392 (Aug. 30, 1968) [33 FR 14109].

58 See Act of July 29, 1968, Pub. L. No. 90-439, 82 Stat. 454.

59 The Futures Interpretive Release provides two examples at Q & A No. 17 that explain when equity securities underlying a security future that requires physical settlement should be counted for purposes of determining whether the purchaser of the security future is subject to Regulation 13D-G by operation of Rule 13d-3(d)(1).

achieve the purpose of Section 13 given the person's potential to influence or change control of the issuer.[60]

Following initial consultation with the prudential regulators and the Secretary of the Treasury, we preliminarily believe that:

- A person's right to acquire an equity security within 60 days based on the purchase or sale of a security-based swap is no different from a right to acquire the underlying equity security that exists independently from a security-based swap. A right to acquire an equity security within 60 days is comparable to direct ownership of the equity security because direct ownership is contingent, in some cases, only upon the exercise of that right and may result in the potential to change or influence control of the issuer upon acquisition of the equity security for which the right is exercisable. Security-based swaps, therefore, can provide incidents of ownership comparable to direct ownership of the underlying equity security within the meaning of Section 13(o) to the extent that the security-based swap confers a right to acquire an equity security within 60 days;
- A person who acquires or holds, with the purpose or effect of changing or influencing control of an issuer, a right to acquire an equity security based on the purchase or sale of a security-based swap is no different from a person who acquires or holds a right to acquire an equity security with the purpose of changing or influencing control of the issuer that exists independently from a security-based swap. Rights acquired or held

60 See Filing and Disclosure Requirements Relating to Beneficial Ownership, Release No. 34-14692 (Apr. 21, 1978) [43 FR 18484].

in this context may be used in furtherance of a plan or proposal to change control of the issuer, and such rights to acquire equity securities may otherwise influence an issuer if held by a person intending to effect a change of control transaction or preserve or influence control of an issuer. Security-based swaps, therefore, can provide incidents of ownership comparable to direct ownership of the underlying equity security within the meaning of Section 13(o) to the extent that the security-based swap confers a right to acquire an equity security to a person that holds the right with the purpose or with the effect of changing or influencing control of the issuer or otherwise in connection with or as a participant in any transaction having such purpose or effect; and

- Retaining the existing regulatory treatment of security-based swaps under Rule 13d-3(d)(1) is necessary to achieve the purpose of Section 13 so that Sections 13(d) and 13(g) continue to require the filing of beneficial ownership reports that disclose certain transactions by persons who have the ability or potential to change or influence control of the issuer. These persons may have the means to acquire significant amounts of equity securities based in whole or in part upon the purchase or sale of a security-based swap, and therefore the potential to effect a change of control transaction or preserve or influence control of an issuer. In the case of Schedule 13D filers, these persons would be required to disclose their plans or proposals. Disclosures made in beneficial ownership reports are in the public interest and necessary for the protection of investors because they provide information about certain transactions and related acquisitions of beneficial ownership that: could disclose a potential shift in corporate control; impact the transparency and efficiency of our capital markets; and contribute to price discovery.

Request for Comment

1. In lieu of readopting the existing language of Rules 13d-3(a), 13d-3(b), and 13d-3(d)(1), should we instead adopt a new rule or amend the existing rules to specify the circumstances in which a purchase or sale of a security-based swap may confer a contingent or other interest in an equity security that, if held, could result in a person being deemed a beneficial owner for purposes of Sections 13(d) and 13(g)?
2. Are there any other rules or disclosure requirements that should be readopted or amended, such as Item 403 of Regulation S-K,[61] to preserve their existing application following effectiveness of Section 13(o)?
3. Should the Commission and/or staff provide interpretive guidance regarding how to provide disclosure with regard to security-based swaps in Schedules 13D or 13G? If so, what type of interpretive guidance would be appropriate?
4. How common is the use of security-based swaps to obtain incidents of ownership, such as voting or investment power, comparable to direct ownership in an issuer?

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61 Item 403 of Regulation S-K requires an issuer to disclose in certain filings the name and amount of beneficial ownership held by any person known to be the beneficial owner of more than five percent of a class of its voting securities. Item 403 also requires the issuer to identify the name and amount of beneficial ownership held by each of its directors, director nominees and executive officers, regardless of whether the person's beneficial ownership exceeds five percent. We have not proposed to readopt Item 403 of Regulation S-K because Item 403 provides that the disclosures required are to be determined in accordance with the beneficial ownership determinations made under Rule 13d-3.

5. Are there other factors or features of security-based swaps we should consider for purposes of making the determinations required under Section 13(o) with regard to the relevant provisions of Rule 13d-3?

6. Does voting or investment power, a scheme to evade beneficial ownership reporting, or a right to acquire an equity security, when each arises from the purchase or sale of a security-based swap, differ materially from when each exists independently from a security-based swap?

B. Section 16 Beneficial Ownership Rules

1. Rule 16a-1(a)(1)

We are proposing to readopt without change a portion of Rule 16a-1(a)(1)[62] to preserve, solely for purposes of determining whether a person is a ten percent holder, the application of the relevant provisions within Rule 13d-3 to a person who uses a security-based swap. The proposed readoption of Rule 16a-1(a)(1) would not change the rule's provision that shares held by institutions eligible to file beneficial ownership reports on Schedule 13G that are held for clients in a fiduciary capacity in the ordinary course of business are not counted for purposes of determining ten percent holder status.[63]

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62 We propose to readopt the portion of Rule 16a-1(a)(1) that precedes the proviso applicable to qualified institutions. The relevant portion of Rule 16a-1(a)(1) proposed for readoption reads as follows: "(a) The term <u>beneficial owner</u> shall have the following applications: (1) Solely for purposes of determining whether a person is a beneficial owner of more than ten percent of any class of equity securities registered pursuant to section 12 of the Act, the term "beneficial owner" shall mean any person who is deemed a beneficial owner pursuant to section 13(d) of the Act and the rules thereunder...."

63 Securities not held in such a fiduciary capacity, however, must be counted in determining whether a Schedule 13G qualified institutional investor is a ten percent holder. This exclusion applies only to qualified institutions who acquire or hold securities of the issuer in the ordinary course of business without the purpose or effect of influencing or changing control, and thereby qualify to use Schedule 13G pursuant to Rule 13d-1(b)(1)(i). The exclusion does not apply to persons who qualify to use

Following initial consultation with the prudential regulators and the Secretary of the Treasury, we preliminarily believe that:

- For the same reasons and in the same circumstances as described above for Rule 13d-3(a), Rule 13d-3(b) and Rule 13d-3(d)(1), solely for purposes of determining whether a person is a ten percent holder subject to Section 16, the purchase or sale of a security-based swap, or class of security-based swap, can provide incidents of ownership comparable to direct ownership of the equity security within the meaning of Section 16; and
- The inclusion of equity securities based on the purchase or sale of a security-based swap, or class of security-based swap, for purposes of calculating ten percent holder status is necessary to achieve the purpose of Section 16, so that Section 16 continues to reach all persons that, under the Section 16 regime, are presumptively deemed to have access to inside information based on influence or control of the issuer through ownership of equity securities.

2. Rule 16a-1(a)(2)

The proposal to readopt without change a portion of Rule 16a-1(a)(2)[64] is intended solely to preserve the existing Section 16(a) reporting of security-based swap holdings and

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Schedule 13G as passive investors pursuant to Rule 13d-1(c), or as exempt investors pursuant to Rule 13d-1(d).

64 We propose to readopt the portion of Rule 16a-1(a)(2) that precedes subparagraph (ii). The relevant portion of Rule 16a-1(a)(2) proposed for readoption reads as follows: "(2) Other than for purposes of determining whether a person is a beneficial owner of more than ten percent of any class of equity securities registered under Section 12 of the Act, the term beneficial owner shall mean any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, has or shares a direct or indirect pecuniary interest in the equity securities, subject to the following: (i) The

transactions and correspondingly to prevent the potential use of security-based swaps to engage in short-swing trading outside the scope of Section 16(b) short-swing profit recovery. The proposal to readopt would not change or otherwise affect any aspect of the pecuniary interest analysis and treatment of derivative securities under Section 16.

Following initial consultation with the prudential regulators and the Secretary of the Treasury, we preliminarily believe that:

- Because an insider's opportunity to profit through a security-based swap is no different from the opportunity to profit through transactions in any other fixed-price derivative security, and hence no different from the opportunity to profit through transactions in the underlying equity security, holdings and transactions in security-based swaps that are fixed-price derivative securities can provide incidents of ownership comparable to direct ownership of the underlying equity security within the meaning of Section 13(o); and
- Retaining the existing treatment of security-based swaps is necessary to achieve the purpose of Section 16 so that Section 16 continues to reach holdings and transactions that insiders can potentially use to profit based on misuse of inside information.

Request for Comment

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term pecuniary interest in any class of equity securities shall mean the opportunity, directly or indirectly, to profit or share in any profit derived from a transaction in the subject securities."

7. In lieu of readopting the existing language of Rule 16a-1(a)(1), should the rule instead be amended to specifically reference security-based swaps? If so, in what manner?
8. In lieu of readopting the existing language of Rule 16a-1(a)(2), should the rule or any related rule that governs the treatment of derivative securities under Section 16 instead be amended to specifically reference security-based swaps? If so, in what manner?
9. Are there other factors that we should consider for purposes of making the determinations required under Section 13(o) with regard to Rule 16a-1(a)(1)?
10. Are there other factors that we should consider for purposes of making the determinations required under Section 13(o) with regard to Rule 16a-1(a)(2)?

C. General Request for Comment

We request and encourage any interested person to submit comments on any aspect of our proposals, other matters that might have an impact on the proposals, and any other suggestions for changes. We solicit comments particularly from the point of view of issuers, shareholders, prospective investors, financial analysts, and market participants. With respect to any comments, we note that they are of greatest assistance to our rulemaking initiative if accompanied by supporting data and analysis of the issues addressed in those comments and by alternatives to our proposals where appropriate.

III. PAPERWORK REDUCTION ACT

The rule proposals affect "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995, the PRA.[65] An agency may not conduct

[65] 44 U.S.C. 3501 et seq.

or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. We already have control numbers for Schedules 13D (OMB Control No. 3235-0145) and 13G (OMB Control No. 3235-0145) and Forms 3 (OMB Control No. 3235-0104) and 4 (OMB Control No. 3235-0287) and 5 (OMB Control No. 3235-0362). These schedules and forms contain item requirements that outline the information a reporting person must disclose.

A. Background

We are proposing to readopt without change portions of the rules enabling determinations of beneficial ownership to be made for purposes of Sections 13(d), 13(g) and 16 of the Exchange Act. The proposals are intended to clarify that following the effective date of Section 13(o), security-based swaps will remain within the scope of these rules to the same extent as they are now.

B. Burden and Cost Estimates Related to the Proposed Amendments

Preparing and filing a report on any of these schedules or forms is a collection of information. The hours and costs associated with preparing the disclosure, filing the schedules or forms and retaining records required by these rules constitute reporting and cost burdens imposed by each collection of information. If the rules we propose are readopted, reporting persons will remain obligated to disclose the same information that they were previously required to report on these schedules or forms. We therefore believe that if the rules are readopted, the overall information collection burden will remain approximately the same because beneficial ownership will remain reportable on the same basis as it is now.

C. Request for Comment

We request comment on this Paperwork Reduction Act Analysis. Pursuant to 44 U.S.C. 3506(c)(2)(B), we solicit comments to:

- evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility;
- determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and
- evaluate whether there are ways to minimize the burden of the collection of information on those persons who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons submitting comments on the collection of information requirements should direct the comments to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should send a copy to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, with reference to File No. S7-10-11. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-10-11, and be submitted to the Securities and Exchange Commission, Office of Investor Education and Advocacy, 100 F Street N.E., Washington, DC 20549-0123.

IV. ECONOMIC ANALYSIS

A. Introduction

Section 23(a)(2) of the Exchange Act requires us, when adopting rules under the Exchange Act, to consider the impact on competition that the rules we adopt would have, and prohibits us from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of that Act.[66] Further, Section 3(f) of the Exchange Act[67] and Section 2(c) of the Investment Company Act[68] require us, when engaging in rulemaking where we are required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation. We have considered and discussed below the effects of the rules proposed for readoption on efficiency, competition, and capital formation, as well as the benefits and costs associated with the proposed rulemaking.

In order to more fully analyze the potential effects of readopting rules that are designed to preserve the regulatory status quo upon the effectiveness of Section 13(o), we have performed the analysis below in two separate ways. First, we analyze the impact of the proposed readoption compared to the status quo, in which the rules already apply to a person

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66 15 U.S.C. 78w(a)(2).

67 15 U.S.C. 78c(f).

68 15 U.S.C. 80a-2(c).

who purchases or sells a security-based swap. Second, we analyze the impact as if our rules did not already apply to persons who purchase or sell security-based swaps.

B. Benefits, Including the Impact on Efficiency, Competition and Capital Formation

1. When the Rules We Propose to Readopt Already Apply to Persons Who Purchase or Sell Security-Based Swaps

The proposal to readopt certain provisions of Rule 13d-3 and Rule 16a-1 would preserve the continued administration of existing rules adopted to improve the transparency of information available to investors, issuers and the marketplace. The proposal is intended to preserve that transparency regarding beneficial ownership positions and the intentions of persons who hold such positions, as well as the holdings of and transactions by Section 16 insiders. We are proposing to readopt, without change, rules that, when applied, may result in disclosure of beneficial ownership and insiders' holdings and transactions in equity securities. In addition, one of the rules proposed for readoption, Rule 16a-1(a)(2), also identifies transactions that may be subject to the private right of action to recover short-swing profit for the issuer provided by Section 16(b).

The proposal is being made solely to preserve the regulatory status quo regarding beneficial ownership reporting under Sections 13(d) and (g), Section 16 insider status as a ten percent holder, insider holding and transaction reporting under Section 16(a), and insider short-swing profit liability under Section 16(b). Application of the rules also will provide certainty regarding the Section 16(b) private right of action to recover insiders' short-swing profits for the issuer. Because the rules we propose are already in place and will remain unchanged, readoption and effectiveness of these rules should have minimal benefits, and little, if any, new effect on efficiency, competition, or capital formation or on the persons required to make the disclosures as a result of the application of the rules. Beneficial owners who use security-based swaps are already subject to these rules and are required to make any applicable disclosures. Because only a limited number of beneficial ownership reports contain disclosure that relates to security-based swaps, the potential effect of this rulemaking should be minimal. Shareholders, issuers, market participants and any other persons who rely upon the disclosures being made as a result of application of the rules similarly will receive little, if any, new benefit and are unlikely to experience any new impact on efficiency, competition or capital formation because the regulatory environment will remain the same as it is today.

2. If the Rules We Propose Did Not Already Apply to Persons Who Purchase or Sell Security-Based Swaps

If one were to analyze the effect of readopting the rules we propose as if they did not already apply to a person who purchases or sells a security-based swap, there would be new benefits, as well as a beneficial effect on efficiency, competition and capital formation. These benefits could extend to beneficial owners required to comply with disclosure requirements as a result of the application of the rules we propose to readopt. These benefits also may extend to persons relying upon these disclosures, including prospective investors, shareholders, issuers, and other market participants. Any such benefits, if realized, would be attributable both to the removal of any regulatory uncertainty and to the resulting preservation of transparency.

a. Benefits, Including the Impact on Efficiency

Applying the rules to a person who purchases or sells a security-based swap confers a benefit to market participants by providing market transparency and removing, in some cases, information asymmetry. Prospective investors, shareholders, issuers and other market participants benefit from the transparency provided through disclosure made available by persons subject to Sections 13 and 16. For example, a Schedule 13D filing may disclose a potential change of control transaction and assist a shareholder in making an investment decision that would maximize the return on an investment. Disclosures made on Schedule 13G may identify for the marketplace important investment decisions made by institutional investors and other large shareholders or may provide notice to investors, issuers and the market regarding voting blocks of securities that have the potential to affect or influence control of an issuer.

Applying the rules to a person who purchases or sells a security-based swap assures that Section 16 will reach a person that, under the Section 16 regime, is presumptively deemed to have access to inside information based on influence or control of the issuer through equity ownership. In addition, applying the rules to a person who purchases or sells a security-based swap means that an insider (whether an officer, director, or ten percent holder) is required to report beneficial ownership with respect to transactions and holdings in a security-based swap that confers an indirect pecuniary interest in issuer equity securities. These reports, like other Section 16(a) reports, may provide shareholders and other market participants with useful information regarding insiders' views of the performance or prospects of the issuer.

Transparency of trading by persons covered by Sections 13 and 16, and transparency of accumulations of material ownership blocks or voting power based on the purchase or sale of a security-based swap, would increase informational efficiency in securities markets in particularly important areas, especially where a Schedule 13D filing may be the first required disclosure of an intended change of control of an issuer. Transparency confers a benefit by assuring the availability of information upon which investors may rely to make informed investment and voting decisions.

The level of transparency provided by Rules 13d-1(a) and 16a-1 also may contribute to market efficiency because it could help facilitate the accurate pricing of securities. If the rules did not apply to a person who purchases or sells a security-based swap, investors and market participants, such as financial analysts and broker dealers, would not have information regarding the use of security-based swaps by persons subject to Sections 13 and 16, including major investors. The transparency provided by the application of our rules should help the market accurately price securities and may enable purchasers and sellers of securities to receive a benefit by avoiding costs, if any, associated with participation in transactions based on mispriced securities. For example, market efficiency should increase because the market will have readily available information about acquisitions of securities that involve the potential to change or influence control of an issuer in connection with the purchase or sale of a security-based swap. If persons who purchase or sell security-based swaps were excluded from this regulatory scheme, an incentive could arise to use security-based swaps to effect or influence the outcome of a change of control transaction. In addition, the pricing of a security would not readily reflect, if at all, ownership interests in the issuer derived from security-based swaps. In such circumstances, the application of the rules we propose for readoption would have the benefit of eliminating this incentive while increasing the quality of information available to price securities.

b. Benefits, Including the Impact on Competition

Public availability of information about the existence of persons who use security-based swaps and have the potential to change or influence control of the issuer affects competition in the market for corporate control. If bidders that use securities-based swaps comply with the beneficial ownership disclosure requirements, the balance Congress sought to strike between issuers and prospective bidders will not tip away from issuers.[69] Providing equal access to information regarding persons who use security-based swaps and have the ability to change or influence control of an issuer reinforces a legislative objective of Section 13(d) by assuring that a person will not be able to implement a change of control transaction by means of a large, undisclosed position. Applying our rules to persons who purchase or sell security-based swaps enables issuers to consider information about competitors in the market for corporate control, including those who may be able to offer a new or competing strategic alternative. Schedule 13D and 13G filings also may deliver greater certainty to market participants who make strategic, voting, or investment decisions wholly or partly based upon the information disclosed, and could reduce speculation about future plans or proposals relating to an issuer. For example, market participants may not be discouraged from introducing strategic plans or proposals to an issuer out of concern that an undisclosed

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[69] See note 22 above.

interest in the issuer derived from a security-based swap could interrupt execution of their plan or proposal.

Section 16 is intended to provide the public with information about the securities transactions and holdings of officers, directors, and ten percent holders, and to mitigate informational advantages they may have in trading issuer securities. Applying Rule 16a-1(a)(1) to beneficial ownership based on the purchase or sale of a security-based swap discourages persons from unfairly profiting in trades based on the ability to become a ten percent holder partly or wholly based on the use of security-based swaps without becoming subject to Section 16. Applying Rule 16a-1(a)(2), which defines "beneficial ownership" based on pecuniary interest in issuer equity securities, to persons who purchase or sell security-based swaps prevents the development of a trading market potentially favoring any insider (whether an officer, director, or ten percent holder) to the extent that:

- holdings and transactions involving security-based swaps may not be reported, thereby depriving investors of potentially useful information; and
- insiders have the opportunity to misuse their potential informational advantages in trading without regard to potential short-swing profit liability.

c. Benefits, Including the Impact on Capital Formation

Making information publicly available generally lowers an issuer's cost of capital and facilitates capital formation, in comparison to what the cost of capital otherwise might be if the rules did not already apply to a person who purchases or sells a security-based swap. If the rules apply to a person who purchases or sells a security-based swap, the resulting transparency could favorably affect investor confidence in the capital markets and thereby not compromise capital formation.[70] If our rules require persons who use security-based swaps to provide disclosures in Schedules 13D and 13G and Forms 3, 4 and 5, investors will not insist on a higher risk premium in publicly-traded equity securities and consequently reduce capital formation. Informed investor decisions generally promote capital formation.[71]

In addition, market participants would benefit from the predictability associated with a regulatory environment in which all persons who have the potential to influence or change control of an issuer are definitively subject to the same beneficial ownership reporting rules. If there were questions as to whether our rules applied to persons who purchase or sell security-based swaps, market participants would have to accept more operational and legal risk because of the potentially unregulated treatment of persons who use security-based swaps with incidents of ownership comparable to direct ownership, as well as persons who have arrangements, understandings, or relationships concerning voting and/or investment power, the opportunity to acquire equity securities, or a plan or scheme to evade Sections 13(d) and 13(g) in connection with the purchase or sale of a security-based swap. By applying our rules to all persons who have the potential to influence or change control of the issuer, market participants would have assurance that securities pricing may reflect information derived from security-based swaps when Sections 13(d), 13(g), and 16 require reporting. The certainty provided by this consistent regulatory treatment could foster

70 See Luigi Guiso et al., Trusting the Stock Market, 63 J. FIN. 2557 (2008) (finding that trust in the fairness of the financial system is correlated with higher levels of stock market participation).

71 See Merritt B. Fox, Randall Morck, Bernard Yeung & Artyom Durnev, Law, Share Price Accuracy, and Economic Performance: the New Evidence, 102 Mich L. Rev. 331 (2003) (empirical study of the value of disclosure requirements in enhancing investment efficiency); see also Studies in Resource Allocation Processes at p. 413 (Kenneth J. Arrow & Leonid Hurwicz eds., 2007) (explaining the relationship between informational efficiency and Pareto efficiency of resource allocation).

investor confidence and participation in the capital markets generally, and should not impair capital formation.

The rules we propose for readoption also would provide the SEC access to ownership and transaction information that would not be available if the rules did not already apply to a person who purchases or sells a security-based swap. The availability of this data should enhance the ability of the Commission and its staff to study and address issues that relate to this information. Ready access to this information also will continue to enable the Commission to exercise efficiently its enforcement mandate in this market segment, and thereby confer a benefit to all market participants by offering assurance that the integrity of security pricing is protected, and is otherwise consistent with the legislative purpose of Sections 13(d), 13(g), 13(o), and 16.

C. Costs, Including the Impact on Efficiency, Competition and Capital Formation

1. When the Rules We Propose Already Apply to Persons Who Purchase or Sell Security-Based Swaps

We preliminarily believe that the rules we propose would not, as a practical matter, impose any new costs on market participants, given that the proposed rulemaking is intended only to preserve the regulatory status quo. Although it is difficult to determine the number of entities and the costs to entities that are required to comply with the rules we propose to readopt, we believe that readoption of the rules would result in minimal, if any, costs to any person or entity (either small or large) and would have little, if any, burden on efficiency, competition or capital formation because the regulatory environment will remain the same as it is today.

Regulation 13D-G currently applies to any person that acquires or is deemed to acquire or hold beneficial ownership of more than five percent of certain classes of equity securities. The proposed readoption of the relevant provisions of Rule 13d-3 would not result in any change to the beneficial ownership reporting obligations of the persons now subject to the beneficial ownership regulatory provisions. Similarly, Section 16 applies to any person that acquires or is deemed to acquire more than ten percent of certain classes of equity securities, and the proposed readoption of Rule 16a-1(a)(1) would not result in any change in determining whether a person is subject to Section 16 as a ten percent holder. Further, for all insiders, the requirements for Section 16(a) reporting and Section 16(b) liability are based on whether the insider has a pecuniary interest in the securities, including indirectly through ownership of and transactions in fixed-price derivative securities, such as security-based swaps, whether settled in cash or stock. Accordingly, the proposed readoption of Rule 16a-1(a)(2) would not result in any change in determining reportable holdings and transactions, or transactions subject to short-swing profit recovery.

Because the rules proposed for readoption are applied today in determining whether a person is required to report beneficial ownership and insiders' holdings and transactions on Schedules 13D and 13G and Forms 3, 4 and 5, we do not believe the proposed rules will alter the costs associated with compliance. These schedules and forms already prescribe beneficial ownership information that a reporting person must disclose, and the proposed rulemaking does not broaden the scope of the information required to be reported on the respective schedules and forms. The compliance burden associated with completion of the relevant schedule or form may be greater or lesser depending on the relative simplicity of the beneficial ownership interest. We recognize that the cost of complying with the beneficial ownership reporting regime can include the cost of analyzing whether the particular interest requires reporting. If it is determined that the interest held constitutes beneficial ownership, and the amount of the beneficial ownership interest exceeds the relevant threshold, the owner must complete and file a schedule and/or form. The compliance burden associated with the readopted rules, however, including costs associated with legal and other professional fees, may decrease because of the regulatory certainty that this rulemaking is providing. Furthermore, the persons incurring this compliance burden may already be subject to a reporting obligation based on an earlier application of these rules, and may not be reporting beneficial ownership for the first time as a direct result of the purchase or sale of security-based swaps.

If the rules we propose are readopted, reporting persons will remain obligated to disclose the information currently required to be reported on these schedules or forms. We therefore believe that the overall compliance burden of the rules we propose to readopt will remain the same. In addition, we do not believe that compliance costs, or the disclosure provided to effect compliance, will affect competition among filers.

We also believe that shareholders, issuers, market participants and any other persons who rely upon the disclosures being made as a result of application of the rules we propose similarly will not be subjected to any new cost, or experience any new impact on efficiency, competition or capital formation because the rules we propose to readopt are already in place and will remain unchanged.

2. If the Rules We Propose Did Not Already Apply to Persons Who Purchase or Sell Security-Based Swaps

Costs could increase for a person who purchases or sells a security-based swap and immediately or eventually incurs the cost of filing or amending a beneficial ownership report if the person did not already determine that a reporting obligation existed based on his or her purchase or sale of a security-based swap. Further, an insider could incur costs from potential short-swing profit recovery arising out of a transaction in a security-based swap.

Application of our rules to a person who purchases or sells a security-based swap may affect competition. For example, a person who becomes a ten percent holder partly or wholly based on the use of a security-based swap would not be in a position to profit in trades prompted by a statutorily presumed informational advantage accentuated by the absence of a reporting requirement. In addition, beneficial owners who compete in the market for corporate control would lose a competitive advantage upon the required disclosure of their beneficial ownership positions and any plans or proposals.

Upon application of the rules we propose to readopt, beneficial owners may accomplish their objectives with less efficiency, and the completion of change of control transactions may be delayed, due to potential interruptions that may arise or alternatives that might emerge as a result of public disclosures. If our rules did not already apply to a person who purchases or sells a security-based swap, that person could accumulate a large beneficial ownership position through the use of a security-based swap without public disclosure. This beneficial ownership position otherwise could have been used to implement or influence the outcome of a change of control transaction without alerting an issuer or the marketplace of these intentions. We believe, however, that the benefits of our rules would justify these costs.

The impact, if any, of the readoption of the rules we propose on capital formation should be insignificant. Compliance costs arising under the beneficial ownership reporting regime based on the purchase or sale of a security-based swap are not expected to redirect capital that otherwise could have been allocated to capital formation. Capital formation should not be affected by a possible decline in the use of security-based swaps resulting from the application of our rules to a person who purchases or sells a security-based swap, given that capital formation ordinarily is not dependent upon the proceeds from transactions in security-based swaps.

D. Request for Comment

We request comment on the costs and benefits associated with the individual rules, including identification and assessments of any costs and benefits not discussed in this analysis. In addition to the specific inquiries made throughout this release, we solicit comments on the usefulness of the rule proposals to reporting persons, registrants, and the marketplace at large. We encourage commentators to identify, discuss, analyze, and supply relevant data, information, or statistics regarding any such costs or benefits, as well as any costs and benefits not already defined. We also request qualitative feedback on the nature of the benefits and costs described above. Finally, we also request comment on the following:

- Would readoption of the rules promote efficiency, competition and capital formation?

- Would the proposed rules, if readopted, have an adverse effect on competition or impose a burden on competition that is neither necessary nor appropriate in furthering the purposes of the Exchange Act?

Commentators are requested to provide empirical data and other factual support for their views if possible.

V. SMALL BUSINESS REGULATORY ENFORCEMENT FAIRNESS ACT

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,[72] a rule is "major" if it has resulted, or is likely to result in:

- an annual effect on the economy of $100 million or more;
- a major increase in costs or prices for consumers or individual industries; or
- significant adverse effects on competition, investment or innovation.

We request that commentators provide empirical data on (a) the annual effect on the economy; (b) any increase in costs or prices for consumers or individual industries; and (c) any effect on competition, investment or innovation.

VI. REGULATORY FLEXIBILITY ACT CERTIFICATION

We hereby certify pursuant to 5 U.S.C. 605(b) that this proposal, if adopted, would not have a significant economic impact on a substantial number of small entities. This proposal relates to beneficial ownership reporting and reporting by insiders of their transactions and holdings. The proposal would not amend existing rules or introduce new rules, and relates only to the readoption of existing rules. For this reason, it would not

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72 Pub. L. No. 104-121, Title II, 110 Stat. 847, 873.

change the regulatory status quo and therefore the proposal should not have a significant economic impact on a substantial number of small entities.

In proposing to readopt these rules, we have considered their potential impact on the small entities that might be required to complete the schedules and forms. We do not collect information to estimate the number of small entities that would be subject to the rules we propose, if readopted, because the beneficial ownership schedules and forms do not capture specific information about the size of the reporting entity. We also do not collect information about small entities that might obtain beneficial ownership based on the purchase or sale of a security-based swap, or whether such beneficial ownership is directly responsible for triggering a reporting obligation.

Nevertheless, the staff has not noted that there are a significant number of entities of any size making beneficial ownership reports based on the purchase or sale of security based swaps. The incidence of small entities who report beneficial ownership based on the purchase or sale of a security-based swap appears to be rare. Moreover, due to their size, small businesses or small organizations would not ordinarily be expected to make beneficial ownership reports because they are less likely to have funds to make purchases exceeding the sizable thresholds that trigger a reporting obligation.

Finally, in most cases, the existing disclosure obligations are generally not likely to be burdensome for small entities. To the extent a small entity would be required to report beneficial ownership based on the purchase or sale of a security-based swap, it is likely that it could fulfill its reporting obligation by filing an abbreviated Schedule 13G so long as it does not hold beneficial ownership with the purpose or with the effect of changing or influencing control of an issuer. Schedule 13G is commonly referred to as a "short form" because less detailed disclosure is required by comparison to Schedule 13D. Accordingly, we do not believe the proposals, if adopted, would have a significant economic impact on small entities.

We encourage written comments regarding this certification. We request in particular that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of the impact.

VII. STATUTORY AUTHORITY

The proposed readoptions contained in this release are made under the authority set forth in Sections 3(a)(11), 3(b), 13, 16, 23(a) of the Exchange Act, Sections 30 and 38 of the Investment Company Act of 1940.

List of Subjects in 17 CFR Part 240

17 CFR Part 240

Reporting and recordkeeping requirements, Securities.

TEXT OF THE PROPOSED AMENDMENTS

For the reasons set out in the preamble, the Commission proposes to amend Title 17, chapter II, of the Code of Federal Regulations as follows:

PART 240 – GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The general authority citation for Part 240 is revised and the following citations are added in numerical order to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e,78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78n-1, 78o, 78o-4, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et seq.; 18 U.S.C. 1350; and 12 U.S.C. 5221(e)(3), unless otherwise noted.

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Section 240.13d-3 is also issued under Pub. L. 111-203 §766, 124 Stat. 1799 (2010).

Section 240.16a-1(a) is also issued under Pub. L. 111-203 §766, 124 Stat. 1799 (2010).

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By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Dated: March 17, 2011

Chairman Schapiro
Commissioner Walter
Commissioner Aguilar
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64098 / March 18, 2011

INVESTMENT ADVISERS ACT OF 1940
Release No. 3176 / March 18, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14298

In the Matter of Jason N. Ginder, Respondent.	ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Jason N. Ginder ("Ginder" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Section III.2 and III.3 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934 and Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. Ginder was an employee of Prudential Securities, Inc., a broker-dealer and investment adviser registered with the Commission, and Prudential Equity Group, LLC, a broker-dealer registered with the Commission.[1] From May 1989 through the present, Ginder has been a registered representative associated with various broker-dealers registered with the Commission. Ginder, 47 years old, is a resident of New Fairfield, Connecticut.

2. On March 9, 2011, a final judgment was entered by consent against Ginder, permanently enjoining him from future violations of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, in the civil action entitled *Securities and Exchange Commission v. Frederick J. O'Meally, et al.*, Civil Action Number 06 Civ. 6483 (LTS), in the United States District Court for the Southern District of New York.

3. The Commission's complaint alleged that, from at least January 2001 until September 2003, Ginder and other Prudential registered representatives defrauded mutual fund companies and the funds' shareholders in order to engage in "market timing" trades on behalf of two hedge fund customers through the use of multiple customer account numbers and financial adviser numbers.

Undertakings

Respondent shall provide to the Commission, within 10 days after the end of the nine-month suspension period described below, an affidavit that he has complied fully with the sanctions described in Section IV below.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Ginder's Offer.

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b)(6) of the Exchange Act and Section 203(f) of the Advisers Act, that Respondent Ginder be, and hereby is suspended from association with any broker, dealer,

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[1] On August 28, 2006, the Commission issued a settled order finding that Prudential Equity Group, LLC, formerly known as Prudential Securities, Inc., violated the antifraud and other provisions of the federal securities laws in connection with the use of fraudulent and deceptive practices by numerous Prudential registered representatives to evade mutual funds' limitations on market timing. *See Prudential Equity Group,* Rel. No. 34-54371.

investment adviser, municipal securities dealer, or transfer agent, and from participating in any offering of penny stock for a period of nine (9) months, effective on the second Monday following the entry of this Order.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34-64099; File No. S7-11-11]

[RIN: 3235-AL11]

Proposed amendments to Rule 17Ad-17; Transfer agents', brokers', and dealers' obligation to search for lost securityholders; paying agents' obligation to search for missing securityholders

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: Section 929W of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") added subsection (g), "Due Diligence for the Delivery of Dividends, Interest, and Other Valuable Property Rights" to Section 17A of the Securities Exchange Act of 1934 ("Exchange Act"). Subsection (g) directs the Securities and Exchange Commission ("Commission") to revise Exchange Act Rule 17Ad-17, "Transfer Agents' Obligation to Search for Lost Securityholders" to: extend to brokers and dealers the requirement of Rule 17Ad-17 to search for lost securityholders; add to Rule 17Ad-17 a requirement that "paying agents" notify "missing security holders" in writing that the paying agent has sent the missing security holder a check that has not yet been negotiated; add to Rule 17Ad-17 an exclusion for paying agents from the notification requirements when the value of the not yet negotiated check is less than $25; and add to Rule 17Ad-17 a provision clarifying that the written notification requirements shall have no effect on State escheatment laws. Subsection (g) also requires the Commission to "adopt such rules, regulations, and orders necessary to implement this subsection no later than 1 year after the date of enactment of this subsection." The Commission is publishing for comment proposed amendments to Rule 17Ad-17 to implement the statutory requirements.

DATES: Comments should be received on or before [insert date 45 days after publication in the Federal Register].

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml);
- Send an e-mail to rule-comments@sec.gov and include File Number S7-11-11 on the subject line; or
- Use the Federal eRulemaking Portal (http://www.regulations.gov) and follow the instructions for submitting comments.

Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-11-11. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/proposed.shtml). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available.

FOR FURTHER INFORMATION CONTACT: Jerry W. Carpenter, Assistant Director, or Thomas C. Etter, Jr., Special Counsel, at (202) 551-5710, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, N.E., Washington, DC 20549-7010.

SUPPLEMENTARY INFORMATION

I. Introduction

On July 21, 2010, the President signed the Dodd-Frank Act into law.[1] The Dodd-Frank Act was enacted to, among other things, promote the financial stability of the United States by improving accountability and transparency in the financial system.[2] Title IX of the Dodd-Frank Act provides the Commission with new tools to protect investors and improve the regulation of securities.[3]

Section 929W of the Dodd-Frank Act added subsection (g) to Section 17A of the Exchange Act ("Section 17A(g)"), which requires the Commission to revise Rule 17Ad-17 under the Exchange Act ("Rule 17Ad-17")[4] to extend the rule's requirement that transfer agents search for "lost securityholders" to brokers and dealers.[5]

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[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[2] See id. at Preamble.

[3] See id. § 901 ("This section may be cited as the 'Investor Protection and Securities Reform Act of 2010'."); Title IX ("Investor Protections and Improvements to the Regulation of Securities").

[4] 17 CFR 240.17Ad-17.

[5] Rule 17Ad-17(b)(2) defines a "lost securityholder" to mean "a securityholder: (i) to whom an item of correspondence that was sent to the securityholder at the address contained in the transfer agent's master securityholder file has been returned as undeliverable; provided, however, that if such item is re-sent within one month to the lost securityholder, the transfer agent may deem the securityholder to be a lost securityholder as of the day the resent item is returned as undeliverable; and (ii) for whom the transfer agent has not received information regarding the securityholder's new address."

Section 17A(g) further directs the Commission to revise Rule 17Ad-17 to provide a requirement that the "paying agent provide a single written notification to each missing security holder that the missing security holder has been sent a check that has not yet been negotiated."[6] Under Section 17A(g), written notification must be sent to a missing security holder no later than seven months after the sending of the not yet negotiated check.[7]

Section 17A(g)(1)(D)(ii) defines "paying agent" to include "any issuer, transfer agent, broker, dealer, investment adviser, indenture trustee, custodian, or any other person that accepts payments from the issuer of a security and distributes the payments to the holders of the security."[8] In addition, Section 17A(g)(1)(D)(i) provides that "a security holder shall be considered a 'missing security holder' if a check is sent to the security holder and the check is not negotiated before the earlier of the paying agent sending the next regularly scheduled check or the elapsing of 6 months after the sending of the not yet negotiated check."[9]

Section 17A(g)(1)(B) and (C) also require that the revisions to the rule: (i) provide an exclusion for paying agents from the notification requirements when the value of the not yet

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[6] Section 17A(g)(1)(A), 15 U.S.C. 78q-1(g)(1)(A). We note that Congress, in drafting Exchange Act Section 17A(g), used a two-word formulation of the term "security holder". In Rule 17Ad-17, however, there is a one-word formulation of the term "securityholder". For the sake of consistency within Rule 17Ad-17, we are proposing to use the term "missing securityholder" in Rule 17Ad-17. Throughout this release, we have used the term "securityholder" when discussing Rule 17Ad-17, and we have used the term "security holder" when discussing Section 929W of the Dodd-Frank Act or Section 17A(g) of the Exchange Act.

[7] Id. Section 17A(g) provides that written notification may be sent along with a check or other mailing subsequently sent to the missing security holder.

[8] Section 17A(g)(1)(D)(ii), 15 U.S.C. 78q-1(g)(1)(D)(ii).

[9] Section 17A(g)(1)(D)(i), 15 U.S.C. 78q-1(g)(1)(D)(i).

negotiated check is less than $25 and (ii) add a provision to make clear that the notification requirements imposed on paying agents shall have no effect on state escheatment laws.[10]

Section 17A(g)(2) requires the Commission to adopt rules, regulations, or orders necessary to implement the provisions of Section 17A(g)(1) no later than one year after the date of enactment of the Dodd-Frank Act.[11] Section 17A(g)(2) further requires the Commission, in proposing such rules, to seek to minimize disruptions to the current systems used by or on behalf of paying agents to process payments to account holders and avoid requiring multiple paying agents to send written notification to a missing security holder regarding the same not yet negotiated check.[12]

II. Rule 17Ad-17

A. Background

The Commission adopted Rule 17Ad-17 in 1997 to address situations where recordkeeping transfer agents lose contact with securityholders by requiring transfer agents to conduct database searches for lost securityholders.[13] As the Commission noted at that time, such loss of contact can be harmful to securityholders because they no longer receive corporate communications or the interest and dividend payments to which they may be entitled.[14] Additionally, their securities and any related interest and dividend payments to which they may be entitled are often placed at risk of being deemed abandoned under operation of state

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[10] See Section 17A(g)(1)(B) and (C), 15 U.S.C. 78q-1(g)(1)(B) and (C).

[11] Section 17A(g)(2), 15 U.S.C. 78q-1(g)(2).

[12] Id.

[13] See Exchange Act Release No. 39176 (Oct. 1, 1997), 62 FR 52229 (Oct. 7, 1997) (adopting Rule 17Ad-17).

[14] See id.

escheatment laws.[15] This loss of contact has various causes, but it most frequently results from: (1) failure of a securityholder to notify the transfer agent of his/her correct address, especially after relocating to a new address or (2) failure of the estate of a deceased securityholder to notify the transfer agent of the death of the securityholder and the name and address of the trustee for the estate.[16]

B. Discussion

The proposed amendments would implement the statutory directive to extend the application of Rule 17Ad-17 to brokers and dealers. Specifically, the Commission proposes to revise paragraph (a) of Rule 17Ad-17 to add the words "broker, or dealer" following the rule's existing references to transfer agents.[17]

The Exchange Act generally defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others,"[18] and a "dealer" as "any person engaged in the business of buying and selling securities for such person's own account though a

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[15] See id. Generally, after expiration of a certain period of time, which varies from state to state but is usually three to seven years, an issuer or its transfer agent must remit abandoned property (e.g., securities and funds of lost securityholders) to a state's unclaimed property administrator pursuant to the state's escheatment laws.

[16] See Exchange Act Release No. 37595 (Aug. 22, 1996), 61 FR 44249 (Aug. 28, 1996) (proposing Rule 17Ad-17).

[17] The proposal also would amend paragraph (a)(1) of Rule 17Ad-17 by: (i) inserting the words "and every broker or dealer that holds customer security accounts" following the words "accounts of lost securityholders"; (ii) inserting the words "and each broker or dealer that holds customer security accounts" following the words "recordkeeping transfer agent"; and (iii) inserting the words "and broker or dealer" following the words "The transfer agent". The proposal would amend paragraph (a)(2) by inserting the words ", or broker or dealer" following the words "transfer agent" and paragraph (a)(3) by inserting the words ", or broker or dealer" following the words "transfer agent" and the words "or customer security account records of the broker or dealer" following the words "master securityholder files". In addition, the proposal would amend paragraph (b)(2)(i) of Rule 17Ad-17 by inserting "or customer security account records of a broker or a dealer" following the words "master securityholder file" and by inserting the words ", or broker or dealer" following the words "securityholder, the transfer agent". The proposal would amend paragraph (b)(2)(ii) by inserting the words "or broker or dealer" following the words "transfer agent".

[18] Exchange Act Section 3(a)(4)(A), 15 U.S.C. 78c(a)(4)(A).

broker or otherwise."[19] The proposed rule would apply to all brokers and dealers. As a practical matter, however, the Commission preliminarily believes that the only brokers and dealers that would have obligations under the amended rule would be those that carry securities for the accounts of "customers" within the meaning of Exchange Act Rule 15c3-3.[20] Such brokers and dealers generally are referred to as "clearing firms" (as opposed to "introducing firms") and tend to be the larger brokerage firms.

The Commission proposes to redesignate current paragraph (c) of Rule 17Ad-17 as paragraph (d) of the rule, as discussed below. Proposed new paragraph (c) would include a requirement that a "paying agent" must provide written notification no later than seven months after the sending of any not yet negotiated check to each "missing securityholder" to inform the missing securityholder that such missing securityholder has been sent a check that has not yet been negotiated. Proposed paragraph (c)(2) of Rule 17Ad-17 would define "paying agent," consistent with the definition in Section 17A(g),[21] to include "any issuer, transfer agent, broker, dealer, investment adviser, indenture trustee, custodian, or any other person" that accepts payments from an issuer of securities and distributes the payments to securityholders. Proposed paragraph (c)(3) of Rule 17Ad-17 would, again consistent with Section 17A(g),[22] provide that a person would be considered a "missing securityholder" if a check is sent to the securityholder and the check is not negotiated before the earlier of the paying agent's sending the next regularly

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[19] Exchange Act Section 3(a)(5)(A), 15 U.S.C. 78c(a)(5)(A).

[20] 17 CFR 240.15c3-3.

[21] Section 17A(g)(1)(D)(ii), 15 U.S.C. 78q-1(g)(1)(D)(ii).

[22] Section 17A(g)(1)(D)(i), 15 U.S.C. 78q-1(g)(1)(D)(i).

scheduled check or the elapsing of six months after the sending of the not yet negotiated check. Proposed paragraph (c)(4) of Rule 17Ad-17 would, as required by Section 17A(g),[23] exclude a paying agent from the notification requirements if the value of the not yet negotiated check is less than $25. Proposed paragraph (c)(5) of Rule 17Ad-17 would, again as required by Section 17A(g),[24] provide that the requirements of paragraph (c)(1) of Rule 17Ad-17 would have no effect on state escheatment laws.

Currently, Rule 17Ad-17(c) requires that every recordkeeping transfer agent shall maintain records to demonstrate compliance with the requirements of the rule.[25] The Commission is proposing to redesignate this provision as paragraph (d) of the rule and to amend the paragraph to also require recordkeeping transfer agents, brokers, dealers, and paying agents to maintain records to demonstrate their compliance with the rule. The rule would require that such records be maintained for a period of not less than three years with the first year in an easily accessible place.[26]

Section 17A(g) further directs the Commission to avoid requiring multiple paying agents to send written notification to a missing security holder regarding the same not yet negotiated check.[27] We do not believe that multiple notifications by different paying agents for a given

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[23] Section 17A(g)(1)(B), 15 U.S.C. 78q-1(g)(1)(B).

[24] Section 17A(g)(1)(C), 15 U.S.C. 78q-1(g)(1)(C).

[25] 17 CFR 240.17Ad-17(c).

[26] Currently, pursuant to Rule 17Ad-7(i), 17 CFR 240.17Ad-7(i), transfer agents must maintain records to show their compliance with Rule 17Ad-17. This same requirement for transfer agents, brokers, dealers, and paying agents would be stated explicitly in proposed amended Rule 17Ad-17. In order to maintain consistency with proposed amended Rule 17Ad-17, we are also proposing a technical change to Rule 17Ad-7(i) so that it would cross-reference proposed amended Rule 17Ad-17(d) rather than proposed amended Rule 17Ad-17(c).

[27] See Section 17A(g)(2), 15 U.S.C. 78q-1(g)(2).

check is a likely scenario under our proposed rule amendments because we do not believe an issuer would use two paying agents for the same distribution. We request comment on the likelihood of such an occurrence and, if such an occurrence is probable with any frequency, on ways to avoid it from happening.

We are also proposing to amend the title of Rule 17Ad-17 to clarify that it would apply to entities other than transfer agents. Specifically, we propose to re-title the rule "Transfer agents', brokers', and dealers' obligation to search for lost securityholders; paying agents' obligation to search for missing securityholders".

Finally, to provide brokers, dealers, and paying agents with sufficient time to develop systems to comply with the proposed amendments to Rule 17Ad-17, we propose to establish a compliance date for the amendments of one year following the date on which the Commission takes final action on this proposal. We preliminarily believe that one year would provide brokers, dealers, and paying agents with ample time to come into compliance without unduly delaying the benefits to securityholders that Congress intended in enacting Section 17A(g).

III. Request for Public Comment

The Commission requests comment on all aspects of the proposed amendments to Rule 17Ad-17. We request comments on how brokers and dealers anticipate complying with the proposed rule's requirement to search for lost securityholders. We also request comment on whether the new term "missing securityholder," and its related requirements and timeframes will be confused with the rule's existing term "lost securityholder" and its related requirements and timeframes. We particularly request comment regarding whether brokers, dealers, and transfer agents, which are also included in the definition of "paying agent," foresee issues that may result from the use of the two terms.[28] With respect to Section 17A(g)(2)'s requirement that in preparing these amendments to Rule 17Ad-17 the Commission shall seek to "minimize disruptions to current systems," we request comment on any potential disruptions that may result from the proposed revisions and how to minimize any such potential disruptions.[29] We are also requesting cost data for implementation of the proposed revisions by industry participants. We are soliciting comments on any burdens to commerce that might result from the proposed rule amendments. Commentators should provide empirical data to support their views.

Finally, we request comments on our proposal to establish a compliance date for the amendments of one year following final action by the Commission.

IV. Paperwork Reduction Act

The proposed amendments to Rule 17Ad-17 would require a new and mandatory "collection of information" within the meaning of the Paperwork Reduction Act of 1995 ("PRA"),[30] consisting of maintaining records in order to comply with and to demonstrate compliance with the rule by brokers and dealers who would be newly added to paragraph (a) of the rule[31] and by paying agents who would be newly added to paragraphs (c) and (d) of the rule.[32] Accordingly, the PRA would be applicable to the proposed rule and would require approval of the Office of Management and Budget. The relevant record collection requirements

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[28] We note that the term "lost securityholder" was adopted as part of Rule 17Ad-17 in 1997, and Congress used the term "missing security holder" when it added new subsection (g) to Exchange Act Section 17A. For the sake of consistency within Rule 17Ad-17, we are proposing to use the term "missing securityholder" in Rule 17Ad-17.

[29] Section 17A(g)(2), 15 U.S.C. 78q-1(g)(2).

[30] 44 U.S.C. 3501 et seq.

[31] 17 CFR 240.17Ad-17(a).

[32] 17 CFR 240.17Ad-17(c) and (d).

would be covered by amendments to paragraph (a) to Rule 17Ad-17, new paragraph (c) of Rule 17Ad-17, and amended and renumbered paragraph (d) of Rule 17Ad-17.[33]

The collection of information under the proposed paragraph (b) of Rule 17Ad-17 is necessary to enable transfer agents, brokers, and dealers and paying agents, as custodians of records that determine the ownership of securities and the entitlement to corporate distributions, to reduce the number of lost and missing securityholders.

The term "paying agents" would include the following approximate numbers of entities: 10,379 issuers that file reports with the Commission; 5,063 broker-dealers registered with the Commission; 536 transfer agents registered with the Commission and the banking agencies; 11,797 registered investment advisers registered with the Commission; 264 indenture trustees; and 896 custodians; for a total of approximately 28,931 entities plus an unknown number in the category of "any other person."

Based on discussions with participants in the securities industry, we are assuming for the purposes of proposed Rule 17Ad-17, that on an annual basis, there will be approximately 250,000 searches by brokers and dealers and 50,000 notifications by paying agents.

A. Paragraph (a)

Under paragraph (a) of the proposed rule amendments, recordkeeping transfer agents, brokers, and dealers would collect the names and addresses of their lost securityholders, and the recordkeeping transfer agents, brokers, and dealers would submit this information to information data bases pursuant to paragraph (b) of the rule. Such data base searches must be conducted without charge to the lost securityholders. Much of the new information required to be collected

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[33] Id.

(such as the taxpayer identification numbers of lost securityholders) generally is already maintained by brokers and dealers and transfer agents so there should not be an additional cost. Therefore, the Commission anticipates that the increased hourly burden imposed by these aspects of the rule revisions would be about two minutes per account per search.[34] Based upon discussions with market participants, adding a corrected address in the event one is found would require approximately three minutes. The burden per account would be no more than five minutes. Assuming 250,000 annual searches by brokers and dealers for lost security holders, the increased hourly burden would be 1,250,000 minutes, or 20,833 hours (1,250,000 divided by 60).

B. Paragraph (c)

Under proposed paragraph (c)(1) of the rule, a paying agent must provide not less than one written notification to each missing securityholder no later than seven months after such securityholder has been sent a check that has not yet been negotiated. The notification may be sent with a check or other mailing subsequently sent to the missing securityholder but must be provided no later than seven months after the sending of the not yet negotiated check. The rule further provides that a paying agent shall be excluded from the notification requirement where the value of the not yet negotiated check is less than $25 and that the requirements of paragraph (c)(1) shall have no effect on state escheatment laws.

The paying agents could include approximately 28,931 identifiable entities as noted previously in this section. However, despite the large number of entities eligible to be paying agents, that number would be limited to those firms that would be able to provide financial

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[34] Based on information provided by the industry, the Commission estimates that broker and dealers will annually search for approximately 250,000 lost securityholders. The Commission estimates that approximately $3.00 will be spent per account in order to conduct a search (comprised of approximately $2.00 for two searches and approximately $1.00 in administration costs). Therefore, the total cost for all brokers and dealers would be $750,000 (250,000 multiplied by $3.00).

services relevant to the rule. The Commission estimates that there would likely be no more than 1,000 entities actually serving as paying agents and that these entities would consist primarily of broker-dealers and transfer agents (including bank transfer agents), the sort of financial institutions that are accustomed to processing checks and other commercial documents, dealing with securityholder issues, maintaining financial records, and serving as intermediaries between issuers and securityholders. We note that, technically, the startup costs to enter the paying agent business, for a business entity already in the financial industry, would appear to be exceedingly modest in that the basic elements of being a paying agent simply involve mailing notification letters, sometimes including checks, and maintaining related financial records. While the entry costs would appear modest, to operate this sort of low margin business profitably would require economies of scale and existing business relationships that presumably would limit the likely number of active paying agents.

If we assume 1,000 paying agents notifying 50,000 missing securityholders with each of the notifications requiring three minutes of labor, we estimate the burden imposed by Rule 17Ad-17(c) on "paying agents" for providing written notification to all "missing securityholders" who have been sent checks that after seven months have not yet been negotiated to be a total of 150,000 minutes or a burden of 2,500 hours (150,000 divided by 60).

C. Paragraph (d)

Proposed paragraph (d) of Rule 17Ad-17 would require that transfer agents, brokers, dealers, and paying agents that are subject to the rule to maintain records necessary to demonstrate their compliance with the rule. The rule also would require transfer agents, brokers, dealers, and paying agents to maintain written procedures that describe their methodology for compliance. The records required by the proposed rule must be maintained for a period of not less than three years, with the first year in an easily accessible place, consistent with Exchange Act Section 17A. Based on discussions with participants in the securities industry, we believe that the annual recordkeeping function for records, which would be processed electronically, would require approximately one hour for every 500 missing securityholder accounts and every 500 lost securityholder accounts. For 250,000 searches by brokers and dealers, the recordkeeping time would be approximately 500 hours. For notification of 50,000 missing securityholders, the recordkeeping time for the paying agents (including any issuer, transfer agent, broker, dealer, investment advisor, indenture trustee, custodian, and any other person) would be approximately 100 hours.

In summary, assuming 250,000 searches by brokers and dealers (20,833 hours + 500 hours = 21,333 hours) and 50,000 notifications by paying agents (2,500 hours + 100 hours = 2,600 hours), the total estimated burden would be 23,933 hours (21,333 hours + 2,600 hours).

V. Costs and Benefits of Proposed Amendments

The costs of this proposal are imposed entirely by Section 929W of the Dodd-Frank Act and Section 17A(g). These statutory costs include, among other things, the application of the requirements of Rule 17Ad-17(a) to brokers and dealers, and the requirements imposed on "paying agents" by proposed Rule 17Ad-17(c) and (d). The costs are not imposed on brokers and dealers or paying agents by the Commission. Accordingly, it is not for the Commission to determine whether these costs are justified by the anticipated benefits of the revised rule.

Nevertheless, we request comment on the potential costs for any necessary modifications to information gathering, management, and record-keeping systems or procedures, as well as any potential costs or benefits resulting from the proposal for brokers, dealers, issuers, transfer agents, investment advisers, indenture trustees, custodians, regulators, or others. Commenters should provide analysis and data to support their views on the costs and benefits associated with the proposal.

The proposed rule changes should provide specific benefits to issuers and U.S. investors, benefits which are not readily quantifiable in terms of dollar value. Nevertheless, the proposal would: (1) invoke the services of transfer agents and brokers and dealers to reduce the number of lost securityholders; (2) invoke the services of all paying agents to reduce the number of missing securityholders; and (3) improve the accuracy of securityholder records. We are seeking comment on how we may better identify and quantify the benefits that may result from the adoption of the proposed amendments.

VI. Initial Regulatory Flexibility Act Analysis

A. Reasons for Proposed Action

This action was expressly directed by legislation (i.e., Section 929W of the Dodd-Frank Act, which added paragraph (g) to Section 17A of the Exchange Act).

B. Objectives and Legal Basis

The objectives of this proposal, as discussed above in Sections I and II, are to help reduce the number of lost and missing securityholders and to further the Commission's mission of protecting investors. The legal basis for the proposal is set forth in Section 17A(g).

C. Small Entities Subject to the Rule

1. Brokers and Dealers

According to Exchange Act Rule 0-10(c),[35] a broker or dealer is a small entity if it: (1) had total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the

[35] 17 CFR 240.0-10(c).

prior fiscal year as of which its audited financial statements were prepared pursuant to Section 240.17a-5(d) or, if not required to file such statements, a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than $500,000 on the last business day of the preceding fiscal year (or in the time that it has been in business, if shorter); and (2) is not affiliated with any person (other than a natural person) that is not a small business or small organization as defined in this section.[36] Of the 5,063 brokers and dealers registered with the Commission, approximately 879 are small brokers or dealers. We note that the proposed amendments to Rule 17Ad-17 would, as a practical matter, apply only to brokers and dealers that carry securities for customer accounts (i.e., clearing firms), which tend to be the larger broker and dealer firms. There are 503 clearing firms registered with the Commission, none of which qualifies as a small business. Accordingly, we do not expect small brokers or dealers to be affected by the amendments to Rule 17Ad-17.[37]

2. Paying Agents

Section 17A(g)(D)(ii) defines the term "paying agent" as including "any issuer, transfer agent, broker, dealer, investment adviser, indenture trustee, custodian, or any other person that accepts payment from the issuer of a security and distributes the payments to the holder of the security." With respect to data for these entities: (1) 10,379 issuers file reports with the Commission of which 1,207 qualify as small businesses;[38] (2) 536 transfer agents registered with

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[36] Paragraph (i) of Rule 0-10, 17 CFR.240.0-10, discusses the meaning of "affiliated person" as referenced in Paragraph (c) of Rule 0-10.

[37] 17 CFR 240.17Ad-17.

[38] See Exchange Act Rule 0-10(a). 17 CFR 240.0-10(a).

the Commission or with the Federal banking agencies of which 135 qualify as small businesses;[39] (3) 5,063 brokers-dealers registered with the Commission of which 879 qualify as small businesses;[40] (4) 11,797 investment advisers registered with the Commission of which 718 qualify as small businesses;[41] (5) 264 indenture trustees of which four qualify as small businesses;[42] and (6) 896 custodians of which 11 qualify as small businesses.[43] The Commission has no supportable basis to estimate the number of small entities with respect to the remaining category (i.e., any other person). As noted herein in Section IV, while approximately 28,931 entities have been identified as potential "paying agents," the Commission preliminarily believes that no more than 1,000 such entities would actually serve as paying agents.

We preliminarily believe that the bulk of paying agent services would be provided by brokerage firms that handle customer securities (which as discussed above, as clearing firms, would not be small entities) and transfer agents (including bank transfer agents), both of which are firms that typically serve as intermediaries between issuers and securityholders.

D. Reporting, Recordkeeping, and Other Compliance Requirements

Proposed new paragraph (d) of Rule 17Ad-17 would require recordkeeping transfer agents, or brokers, or dealers, and paying agents to demonstrate compliance with these provisions and to maintain written procedures that describe the methodology for complying with the provisions. Such records would be required to be maintained for not less than three years,

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[39] See Exchange Act Rule 0-10(h). 17 CFR 240.0-10(h).

[40] See Exchange Act Rule 0-10(c). 17 CFR 240.0-10(c).

[41] See Investment Advisers Act Rule 0-7(a). 17 CFR 275.0-7(a).

[42] See Trust Indenture Act Rule 0-7. 17 CFR 260.0-7.

[43] See 13 CFR 121.201.

the first year in an easily accessible place. Their maintenance would be subject to examination by the appropriate regulatory agency as defined by Section 3(a)(34)(B) of the Exchange Act.[44]

E. Duplicative, Overlapping, or Conflicting Federal Rules

The Commission preliminarily believes there are no rules that duplicate, overlap, or conflict with the proposed rule.

F. Significant Alternatives

With respect to small entities, the Commission considered whether viable alternatives to the proposed rulemaking exist that could accomplish the stated objectives of Section 17A(g) of the Exchange Act and whether they would minimize any significant economic impact of proposed rules on small entities. Specifically, the Commission considered the following alternatives: (1) the establishment of different procedures that take into account the resources available to small entities; (2) the clarification, consolidation, or simplification of compliance and reporting requirements under the proposed rules insofar as they affect small entities; (3) the use of performance rather than design standards; and (4) an exemption from coverage of the rule, or any part thereof, for small entities. However, inasmuch as Section 929W of the Dodd-Frank Act, which added Section 17A(g) to the Exchange Act, expressly requires the proposed revisions, no alternative to the proposed rule amendment appears available at this time.

The Commission encourages the submission of written comments with respect to any aspect of the Initial Regulatory Flexibility Analysis ("IFRA").[45] Those comments should specify costs of compliance with the proposed rule, and suggest alternatives that would accomplish the

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[44] 15 U.S.C. 78c(a)(34)(B).

[45] 5 U.S.C. 603.

objective of the proposed amendments to Rule 17Ad-17. A copy of the IRFA may be obtained by contacting Thomas C. Etter, Jr., Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, N.E., Washington, DC 20549-7010, telephone no. (202) 551-5713.

VII. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

The proposed amendments to the rule should have a neutral effect on efficiency and capital formation and should have no material anticompetitive effects. While we believe the proposed amendments to the rule would apply to all transfer agents, brokers, dealers, and paying agents, they could in theory create a barrier to entry for potential new entrants if the compliance costs associated with searching for and contacting lost or missing securityholders are high enough. The Commission encourages the submission of written comments on Section VII.

VIII. SBREFA Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,[46] a rule is major if it has resulted in or is likely to result in:

- an annual effect on the economy of $100 million or more;
- a major increase in costs or prices for consumers or individual industries; or
- significant adverse effects on competition, investment, or innovation.

We request comment regarding the potential impact of the proposed rule amendments on the economy on an annual basis. We also request that commenters provide empirical data and other factual support for their views.

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[46] 5 U.S.C. 801, et seq. The Regulatory Flexibility Act requires regulatory agencies to consider the impact of their proposed and final regulations on small entities.

IX. Statutory Basis and Text of Proposed Amendments

Statutory Basis

Pursuant to Section 17A(g) of the Exchange Act, 15 U.S.C. 78q-1(g), the Commission proposes to amend § 240.17Ad-7 and § 240.17Ad-17 under the Exchange Act in the manner set forth below.

List of Subjects in 17 CFR Part 240

Reporting and recordkeeping requirements; Securities.

Text of the Amendments

In accordance with the foregoing, the Commission proposes to amend Part 240 of Chapter II of Title 17 of the Code of Federal Regulations as follows:

PART 240 – GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The general authority citation for Part 240 is revised and the following citation is added in numerical order to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78*l*, 78m, 78mm, 78n, 78n-1, 78o, 78o-4, 78p, 78q, 78q-1, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et seq.; 18 U.S.C. 1350; and 12 U.S.C. 5221(e)(3) unless otherwise noted.

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Section 240.17Ad-17 is also issued under Pub. L. 111-203, § 929W, 124 Stat. 1869 (2010).

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2. Section 240.17Ad-7(i) is amended by removing "240.17Ad-17(c)" and adding in its place "240.17Ad-17(d)".

3. Section 240.17Ad-17 is amended by:

a. Revising the heading.

b. Revising paragraph (a)(1).

c. In paragraph (a)(2) adding the phrase ", or broker or dealer" following the word "agent".

d. In paragraph (a)(3) introductory text adding the phrase ", or broker or dealer" following the word "agent".

e. In paragraph (a)(3)(ii) adding the phrase "or customer security account records of the broker or dealer" following the word "files".

f. In paragraph (b)(2)(i) adding the phrase "or customer security account records of a broker or dealer" following the word "file" and adding the phrase ", or broker or dealer" following the phrase "securityholder, the transfer agent".

g. In paragraph (b)(2)(ii) adding the phrase "or broker or dealer" following the word "agent"..

h. Redesignating paragraph (c) as paragraph (d), and adding new paragraph (c).

i. Revise newly redesignated paragraph (d).

The revisions read as follows:

§ 240.17Ad-17 Transfer agents', brokers', and dealers' obligation to search for lost securityholders; paying agents' obligation to search for missing securityholders.

(a)(1) Every recordkeeping transfer agent whose master securityholder file includes accounts of lost securityholders and each broker or dealer that holds customer security accounts shall exercise reasonable care to ascertain the correct addresses of such securityholders. In exercising reasonable care to ascertain such lost securityholders' correct addresses, each recordkeeping transfer agent and each broker or dealer shall conduct two data base searches using at least one information data base service. The transfer agent and broker or dealer shall search by taxpayer identification number or by name if a search based on taxpayer identification number is not reasonably likely to locate the securityholder. Such data searches must be conducted without charge to a lost securityholder and with the following frequency:

(i) Between three and twelve months of such securityholder becoming a lost securityholder and

(ii) Between six and twelve months after the transfer agent's or broker's or dealer's first search for such lost securityholder.

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(c)(1) The paying agent, as defined in paragraph (c)(2) of this section, shall provide not less than one written notification to each missing securityholder stating that such securityholder has been sent a check that has not yet been negotiated. Such notification may be sent with a check or other mailing subsequently sent to the missing securityholder, but must be provided no later than seven (7) months after the sending of the not yet negotiated check.

(2) The term <u>paying agent</u> shall include any issuer, transfer agent, broker, dealer, investment adviser, indenture trustee, custodian, or any other person that accepts payments from the issuer of a security and distributes the payments to the holder of the security.

(3) The securityholder shall be considered a missing securityholder if a check is sent to the securityholder and the check is not negotiated before the earlier of the paying agent's sending the next regularly scheduled check or the elapsing of six (6) months after the sending of the not yet negotiated check.

(4) A paying agent shall be excluded from any notification requirement where the value of the not yet negotiated check is less than $25.

(5) The requirements of paragraph (c)(1) of this section shall have no effect on state escheatment laws.

(d) Every recordkeeping transfer agent, broker, or dealer carrying securities for the accounts of customers, and every paying agent shall maintain records to demonstrate compliance with the requirements set forth in this section which shall include written procedures that describe the transfer agent's, or broker's or dealer's, or paying agent's methodology for complying with this section. Such records shall be maintained for a period of not less than three (3) years with the first year in an easily accessible place.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy

Secretary

Date: March 18, 2011

Chairman Schapiro
Commissioner Walter
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 3177 / March 21, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14300

In the Matter of **REBECCA A. TOWNSEND,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Rebecca A. Townsend ("Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over her and the subject matter of these proceedings, and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. Townsend was the Vice President of Enterprise Trust Company ("Enterprise"), which is a Nevada corporation and an unregistered investment adviser. Townsend is 48 years old and resides in Downers Grove, Illinois.

2. On July 29, 2008, a permanent injunction was entered by consent against Townsend, permanently enjoining her from future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder in the civil action entitled Securities and Exchange Commission v. John H. Lohmeier, et al., Civil Action Number 1:08-CV-1260, in the United States District Court for the Northern District of Illinois.

3. The Commission's complaint alleged that Townsend fraudulently induced hundreds of customers of Advisory Financial Consultants ("AFC"), a registered broker-dealer, to transfer custody of approximately $49 million in mutual funds to Enterprise. The complaint further alleged that, unbeknownst to and without the authorization of the AFC customers, Townsend assisted in placing their mutual funds into margin and other accounts where the AFC customers' securities served as collateral for leveraged margin trading, including options trading and short selling, that was intended to benefit Enterprise's principals, including Townsend, and other Enterprise customers. The complaint alleges that this margin trading was not intended to and did not benefit the AFC customers.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanction agreed to in Respondent Townsend's Offer.

Accordingly, it is hereby ORDERED, pursuant to Section 203(f) of the Advisers Act, that Respondent Townsend be, and hereby is, barred from association with any investment adviser.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64104 / March 22, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14301

In the Matter of **Circadian, Inc.,** **Clean Energy Combustion, Inc. (n/k/a Clean Energy Combustion Systems, Inc.),** **Collectible Concepts Group, Inc.,** **Communitronics of America, Inc. (n/k/a RPM Advantage, Inc.), and** **ConSyGen, Inc.,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents Circadian, Inc., Clean Energy Combustion, Inc. (n/k/a Clean Energy Combustion Systems, Inc.), Collectible Concepts Group, Inc., Communitronics of America, Inc. (n/k/a RPM Advantage, Inc.), and ConSyGen, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Circadian, Inc. (CIK No. 738014) is a void Delaware corporation located in San Jose, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Circadian is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 1995, which reported a net loss of $65,000 for the prior three months. On February 13, 1996, Circadian filed a Chapter 7 petition in the U.S.

Bankruptcy Court for the Northern District of California, which was terminated on December 17, 1999. As of March 15, 2011, the company's common stock (symbol "CKDN") was quoted on OTC Link (previously, "Pink Sheets") operated by OTC Markets Group Inc. ("OTC Link"), had five market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

2. Clean Energy Combustion, Inc. (n/k/a Clean Energy Combustion Systems, Inc.) (CIK No. 1096013) is a Delaware corporation located in Vancouver, British Columbia, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Clean Energy is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2004, which reported a net loss of over $614,000 for the prior nine months. As of March 15, 2011, the company's common stock (symbol "CECU") was quoted on OTC Link, had six market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

3. Collectible Concepts Group, Inc. (CIK No. 1106946) is a void Delaware corporation located in Doylestown, Pennsylvania with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Collectible Concepts is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended November 30, 2007, which reported a net loss of over $2.4 million for the prior three months. On April 26, 2000, an involuntary Chapter 7 petition was filed against Collectible Concepts in the U.S. Bankruptcy Court for the Eastern District of Pennsylvania, which was terminated on June 21, 2000. As of March 15, 2011, the company's common stock (symbol "CCNG") was quoted on OTC Link, had seven market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

4. Communitronics of America, Inc. (n/k/a RPM Advantage, Inc.) (CIK No. 1077385) is a revoked Nevada corporation located in Houston, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Communitronics is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended June 30, 2006. As of March 15, 2011, the company's common stock (symbol "RPMV") was quoted on OTC Link, had five market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

5. ConSyGen, Inc. (CIK No. 844008) is a forfeited Texas corporation located in Tempe, Arizona with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). ConSyGen is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended November 30, 2001, which reported a net loss of over $1.3 million for the prior six months. As of March 15, 2011, the company's common stock (symbol "CSGI") was quoted on OTC Link, had seven market makers, and was eligible for the piggyback exception of Exchange Act Rule 15c2-11(f)(3).

B. DELINQUENT PERIODIC FILINGS

6. As discussed in more detail above, all of the Respondents are delinquent in their periodic filings with the Commission, have repeatedly failed to meet their obligations to file timely periodic reports, and failed to heed delinquency letters sent to them by the Division of Corporation Finance requesting compliance with their periodic filing obligations or, through their failure to maintain a valid address on file with the Commission as required by Commission rules, did not receive such letters.

7. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers of securities registered pursuant to Exchange Act Section 12 to file with the Commission current and accurate information in periodic reports, even if the registration is voluntary under Section 12(g). Specifically, Rule 13a-1 requires issuers to file annual reports, and Rule 13a-13 requires domestic issuers to file quarterly reports.

8. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate for the protection of investors that public administrative proceedings be instituted to determine:

A. Whether the allegations contained in Section II hereof are true and, in connection therewith, to afford the Respondents an opportunity to establish any defenses to such allegations; and,

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or revoke the registration of each class of securities registered pursuant to Section 12 of the Exchange Act of the Respondents identified in Section II hereof, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents.

IV.

IT IS HEREBY ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice [17 C.F.R. § 201.110].

IT IS HEREBY FURTHER ORDERED that Respondents shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220(b) of the Commission's Rules of Practice [17 C.F.R. § 201.220(b)].

If Respondents fail to file the directed Answers, or fail to appear at a hearing after being duly notified, the Respondents, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents, may be deemed in default and the proceedings may be determined against it upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means permitted by the Commission Rules of Practice.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 120 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice [17 C.F.R. § 201.360(a)(2)].

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

March 22, 2011

In the Matter of **Circadian, Inc.,** **Clean Energy Combustion, Inc. (n/k/a Clean Energy Combustion Systems, Inc.),** **Collectible Concepts Group, Inc.,** **Communitronics of America, Inc. (n/k/a RPM Advantage, Inc.), and** **ConSyGen, Inc.,** **File No. 500-1**	**ORDER OF SUSPENSION OF TRADING**

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Circadian, Inc. because it has not filed any periodic reports since the period ended September 30, 1995.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Clean Energy Combustion, Inc. (n/k/a Clean Energy Combustion Systems, Inc.) because it has not filed any periodic reports since the period ended September 30, 2004.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Collectible Concepts Group, Inc. because it has not filed any periodic reports since the period ended November 30, 2007.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Communitronics of America, Inc. (n/k/a RPM Advantage, Inc.) because it has not filed any periodic reports since the period ended June 30, 2006.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of ConSyGen, Inc. because it has not filed any periodic reports since the period ended November 30, 2001.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed companies.

Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed companies is suspended for the period from 9:30 a.m. EDT on March 22, 2011, through 11:59 p.m. EDT on April 4, 2011.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Rel. No. 9197 / March 22, 2011

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 64106 / March 22, 2011

Admin. Proc. File No. 3-13871

In the Matter of RONALD S. BLOOMFIELD, ROBERT GORGIA, VICTOR LABI, JOHN EARL MARTIN, SR., and EUGENE MILLER	ORDER GRANTING EXTENSION

I.

The Chief Administrative Law Judge has moved, pursuant to Commission Rule of Practice 360(a)(3),[1] for an extension of time to issue an initial decision in this proceeding. For the reasons set forth below, we have determined to grant the motion.

On April 27, 2010, we issued an Order Instituting Administrative and Cease-and-Desist Proceedings ("OIP") pursuant to Section 8A of the Securities Act of 1933, and Sections 15(b) and 21C of the Securities Exchange Act of 1934, against: Eugene Spencer Miller, the former President of Leeb Brokerage Services, Inc. ("Leeb"), a broker-dealer, which had been registered with the Commission from March 1999 until July 2007; Robert Gorgia, the former Chief Compliance Officer at Leeb; and three former Leeb registered representatives: Ronald S. Bloomfield, Victor Labi, and John Earl Martin, Sr.

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[1] 17 C.F.R. § 201.360(a)(3).

The OIP alleges, among other things, that Bloomfield, Labi, and Martin offered and sold securities of various corporations to the public when no registration statement was filed or in effect pursuant to the Securities Act, when no exemption from registration was available, and without conducting a reasonable inquiry regarding the securities to determine whether their customers were underwriters or were otherwise engaged in an illegal distribution of securities, in violation of Sections 5(a) and 5(c) of the Securities Act. The OIP further alleges that Gorgia and Miller failed reasonably to supervise Bloomfield, Labi, and Martin, within the meaning of Sections 15(b)(4) and 15(b)(6) of the Exchange Act. In addition, the OIP alleges violations with respect to Leeb's failing to file "Suspicious Activity Reports" related to the transactions at issue, pursuant to the Bank Secrecy Act.[2] The OIP directs the presiding law judge, in this case Chief Judge Murray, to hold a public hearing to take evidence regarding the allegations and the appropriate sanctions, and to issue an initial decision no later than 300 days from the date of service of the OIP, *i.e.*, by April 5, 2011. On February 28, 2011, Chief Judge Murray filed a motion requesting an extension of time until May 5, 2011 to issue an initial decision.

II.

We adopted Rules of Practice 360(a)(2) and 360(a)(3) as part of an effort to enhance the timely and efficient adjudication and disposition of Commission administrative proceedings,[3] setting mandatory deadlines for completion of administrative hearings. We further provided for the granting of extensions to those deadlines under certain circumstances, if supported by a motion from the Chief Law Judge.

The Chief Law Judge supports her request by noting that the record in the case is extensive, consisting of 1744 transcript pages (based on six days of hearings) and approximately 400 exhibits. She further supports her request by citing an unusually heavy workload, involving her presiding over three significant proceedings at roughly the same time. Under the circumstances, we believe that it is appropriate to grant the Chief Law Judge's request and to extend the deadline for issuance of a decision in this matter.

Accordingly, IT IS ORDERED that the deadline for filing the initial decision in this matter be, and it hereby is, extended until May 5, 2011.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

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[2] 31 C.F.R. § 103.19(a)(2).

[3] *See Adopting Release*, Securities Act Rel. No. 8240 (June 11, 2003), 80 SEC Docket 1463.

Commissioner Walter not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9198 / March 23, 2011

SECURITIES EXCHANGE ACT OF 1934
Release No. 64114 / March 23, 2011

INVESTMENT ADVISERS ACT OF 1940
Release No. 3179 / March 23, 2011

INVESTMENT COMPANY ACT OF 1940
Release No. 29615 / March 23, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14304

In the Matter of **ROMAN LYNIUK,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, SECTIONS 15(b) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, SECTIONS 203(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940 AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940 AND NOTICE OF HEARING**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), Sections 15(b)(6) and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act") against Roman Lyniuk ("Respondent" or "Lyniuk").

II.

After an investigation, the Division of Enforcement (the "Division") alleges that:

A. SUMMARY

1. This matter concerns fraudulent conduct by Lyniuk, the founder and manager of Atlantis Capital Management, L.P. (the "Fund"), a small hedge fund located in New York and New Jersey. Respondent created the Fund in late 1996 and managed it through its investment adviser, Atlantis Capital Markets, LLC. From approximately late 1996 through the middle of 2004, the Fund consisted solely of capital provided by Respondent and his friends and family members. By 2004, all or most of that capital had been withdrawn and/or lost through trading. In 2004, Respondent began successfully marketing the Fund to potential outside investors, in part by providing misleading historical trading results to third-party hedge fund information providers.

2. After attracting outside capital, Respondent engaged in egregious self-dealing by obtaining undisclosed compensation of at least $400,000, including rebates on brokerage commissions that were generated through the Fund's trading, and a referral fee of $40,000 in connection with his investment of $500,000 of the Fund's assets in a start-up venture that offered limited liquidity.

3. In August and September 2006, the Fund lost approximately 29% and 57% of its net asset value, respectively. The August losses were trading losses. The September losses resulted from a combination of factors, including a) a write-down of the Fund's investment in the start-up venture, which previously had been carried at face value; b) the transfer of Fund assets to cover losses in Respondent's personal trading accounts; and c) additional trading losses.

4. Most of the Fund's investors sought redemption of their interests shortly after they learned of the disastrous August 2006 losses. Instead of promptly calculating the investors' net asset values and redeeming them, however, Respondent misappropriated most of the remaining funds by transferring money into a new fund and by making unauthorized payments to himself and his friends. Investors eventually received only about 10% of the amount in their capital accounts as of July 31, 2006.

5. Since approximately mid-2006 and as recently as December 2010, Respondent has been attempting to obtain investors for a new fund, Pacific Capital Markets Cayman LDC ("Pacific"). From mid-2007 through December 2010, Respondent had been promoting Pacific through a third-party hedge fund information provider, based on false and misleading information concerning the history, assets under management, and performance of the fund.

B. RESPONDENT

6. Respondent, age 54, resides in Rumson, New Jersey and was the founder and manager of Atlantis Capital Management, L.P. and Atlantis Capital Markets N.A., LLC. Respondent holds Series 3, 7, and 63 licenses and held a variety of positions in

the financial industry prior to starting the Fund. From approximately November 1996 through September 2006 (the "Relevant Period"), Respondent managed Atlantis Capital Management L.P. and Atlantis Capital Markets N.A., LLC. During that period, Respondent was a registered representative associated with a variety of broker-dealers registered with the Commission. From June 2009 to October 2010, Respondent was employed by Tullett Prebon Financial Services LLC, a broker-dealer registered with the Commission, as a registered representative.

C. OTHER RELEVANT ENTITIES

7. At all relevant times, the Fund, Atlantis Capital Management, L.P., was a limited partnership registered in the State of Delaware that was formerly based in New York, New York and Rumson, New Jersey. Respondent founded the partnership in November 1996.

8. At all relevant times, Atlantis Capital Markets N.A., LLC ("Atlantis Capital Markets") was a Delaware limited liability company based in New York, New York and was the General Partner of, and unregistered investment adviser to, the Fund. Respondent was the principal and sole owner of Atlantis Capital Markets.

9. From approximately August 2000 through at least December 31, 2006, Atlantis Capital Markets Securities, LLC ("ACM Securities") was a Delaware limited liability company based in New York, New York. From approximately March 2002 through October 2003, ACM Securities was a registered broker-dealer. Its registration was canceled by Commission order in October 2003. Respondent was the principal and sole owner of ACM Securities.

10. At all relevant times, Respondent made virtually all decisions concerning the management of Atlantis Capital Markets and ACM Securities, exercised complete control over their bank and brokerage accounts, and supervised all trading decisions on behalf of these entities and the Fund.

D. RESPONDENT SOLICITED INVESTORS USING FALSE AND MISLEADING INFORMATION ABOUT THE FUND AND ITS HISTORICAL PERFORMANCE

11. Although the Fund was registered as a partnership in November 1996, it did not become fully operational until 2005. Prior to July 2004, the Fund's trading accounts contained only money provided by the Respondent and his family members. By early 2004, most of the Fund's assets had been withdrawn and/or lost through trading.

12. In 2003, Respondent became acquainted with an individual residing in California. The individual suggested that Respondent market his fund through third-party hedge fund information providers that collect performance information from hedge funds and make that information, together with analysis of that information, available to investors through internet sites and newsletters. The individual also suggested that Respondent establish an internet site of his own and make information available to investors through that site. In early 2004, Respondent entered into an agreement by which

the individual, through a newly-formed corporation ("Marketer A"), would provide marketing services to Respondent and his fund.

13. From approximately July 2004 through March 2006, Respondent offered and sold partnership interests in the Fund to at least 12 investors. Respondent obtained at least $6 million from these investors, most of which were entities or individuals residing in the United States. Some of the early investors withdrew their capital in or before July 2006, receiving the amount of their investment and, in some cases, a small profit.

14. By July 31, 2006, the Fund had nine investors, not including Respondent, who had invested approximately $168,000 of Respondent's own capital. The total net asset value of the Fund as of that date was approximately $10 million.

15. From approximately July 2004 through March 2006, Respondent solicited the investors by means of material misrepresentations and omissions. Respondent (together with Marketer A, which acted at Respondent's direction) provided these investors with documents containing material misstatements concerning the Fund and its history.

16. Respondent (or Marketer A, acting at Respondent's direction) falsely informed potential investors that the Fund had an "eight year track record" of strong performance in both good and bad markets. Among other documents, Respondent made this representation in a due diligence report and questionnaire (the "Due Diligence Report"), which was created in approximately late 2004 and updated in approximately June 2005. The existence of a strong track record in both good and bad markets was material to investors because it suggested that the Fund had, and had successfully employed, a low-risk trading strategy. In fact, although Respondent may have achieved the referenced results for himself and his family, the reported results included assets maintained in non-Fund accounts. In addition, Respondent did not trade Fund assets at all during part of the period from November 1996 through 2004. Respondent knew, or was reckless in not knowing, that the representation concerning the Fund's "eight year track record" was materially misleading.

17. Respondent (or Marketer A, acting at Respondent's direction) falsely informed potential investors, through the Due Diligence Report, that the Fund had had $20 million of assets under management in 1999. In fact, the Fund's assets (which consisted solely of the Respondent's family's capital) at the time were a fraction of that amount.

18. Respondent (or Marketer A, acting at Respondent's direction) falsely informed potential investors, through the Due Diligence Report, that the Fund was audited annually. In fact, as Respondent knew, the Fund had never been audited. Whether the Fund had been audited was material to investors, because the audit provided assurance that the investment adviser's representations about the Fund were accurate.

19. The Fund's marketing materials also specifically stated that the Fund would be audited for 2004. At some point after the marketing materials were

distributed, Respondent determined that an audit should not be performed for 2004, because its cost would be excessive. Respondent continued to represent that the Fund would be audited. Whether the Fund would be audited in the future was material to investors.

20. Respondent (or Marketer A, acting at Respondent's direction) falsely assured potential investors, through the Due Diligence Report, that the Fund had a fund administrator, and that funds could not be withdrawn from the Fund without approval from the fund administrator or auditor. The existence of a requirement that withdrawals be approved by a third party was material to investors because it would provide a check on improper withdrawals of Fund assets. In fact, as Respondent knew, the Fund had never had a fund administrator prior to late 2005, and Respondent had sole signing authority for the Fund's accounts.

21. Although Respondent hired a fund administrator in late 2005, he continued to write checks on the Fund's accounts in 2006, including checks payable to himself, without obtaining a signature from the fund administrator or auditor. Respondent knew that he continued to make withdrawals from the Fund without a signature from the fund administrator or auditor, but he failed to disclose this material fact to investors.

22. Respondent (or Marketer A, acting at Respondent's direction) falsely informed potential investors that the Fund would have a "team of traders," including a specific trader who had exercised investment discretion over Respondent's account at certain times during the 2000-2002 period. In fact, as Respondent knew, that trader had stopped trading for the Fund years before and had repeatedly declined Respondent's requests to resume trading for the Fund.

23. Despite the fact that this individual had previously instructed Respondent to remove his name from the Fund's marketing materials, Respondent distributed materials in 2004, including a version of the Due Diligence Report, that falsely described this individual as "Director of Stock Arbitrage" for the Fund. The marketing materials also falsely represented that a second individual, who also had stopped trading for the Fund years before, would be employed as "stock arbitrageur" for the Fund. These two individuals were the only employees identified in the marketing materials as Fund employees responsible for stock arbitrage trading.

24. According to a section of the marketing materials entitled "breakdown by strategy," stock arbitrage represented 50% of the Fund's strategy.

25. Respondent's misrepresentations concerning the participation of the two individuals referenced in paragraphs 22 through 24 above were material to investors. The misrepresentations falsely suggested that the Fund would employ, and had years of experience employing, a risk-averse stock arbitrage strategy overseen by experienced trading professionals. In fact, the Fund had no such employees and had limited, if any, experience employing that strategy.

26. Respondent (or Marketer A, acting at Respondent's direction) provided investors with a chart, included in the Due Diligence Report, that purported to represent the Fund's monthly returns since 1997. The Fund's purported monthly returns were material to investors. Respondent knew that this chart was false and misleading in that, among other things, it failed to disclose that: a) the returns referenced (if they had been achieved at all) were not exclusively the returns of the Fund, but included those of other accounts that were traded primarily by Respondent and at times by other traders; b) the returns had been achieved (if at all) using riskier strategies and higher leverage than Respondent expected to use for the Fund; and c) the returns did not reflect any expenses other than trading costs, while the Fund would bear substantial costs for administrator's fees, legal fees, accountants' fees, and marketing expenses – expenses that would materially decrease the Fund's returns, particularly if shared among only a few investors.

27. Respondent also manipulated the report of monthly returns in the Due Diligence Report to make his trading strategy appear less risky and more consistent than it was. For the period from November 1999 through June 2001, an accounting review indicated that Respondent's accounts had achieved monthly returns of up to 136%. For months after June 2001, his returns were much lower than his purported returns in the prior period. To make his returns appear more consistent to investors, Respondent's marketing materials reported monthly returns for November 1999 through June 2001 that were approximately 10% of the results his accountant reported. For months after June 2001, Respondent's chart included 100% of the returns reported by his accountant. Respondent intentionally manipulated his returns by dividing his higher monthly returns by ten, because he knew that consistency was important to investors. The returns reviewed by the accountant for the earlier period, while potentially attractive to investors because they were higher, would have been a red flag for investors who wanted low risk and low volatility. Respondent's failure to disclose that he had divided these results by ten was material.

28. Respondent knowingly provided false and misleading information about the Fund's historical performance to Marketer A. Marketer A, acting at Respondent's direction, relayed the false and misleading information to at least two third-party hedge fund information providers, which made the information available to investors through newsletters and over the internet. This information included the same materially misleading information about the Fund's historical returns described in paragraphs 1 through 27 above. Relying on this information, a report from a prominent third-party hedge fund information provider ("Hedge Fund Information Provider A") for the period ending September 30, 2003, listed the Fund as the seventh best performing fund over the past 60 months. Hedge Fund Information Provider A's rankings were based on a proprietary ratio that used the performance information provided by the reporting hedge funds to calculate a ratio that took into account both performance and risk. Respondent featured the Hedge Fund Information Provider A ranking in the Fund's marketing materials, even though he knew it was false and misleading.

29. Respondent knowingly provided false information to Hedge Fund Information Provider A concerning the Fund's assets under management. For example, he represented that the Fund had $5 million dollars in assets under management from January to July 2002. In reality, the Fund had little or no assets under management that year.

Respondent also represented that the Fund had $10 million of assets under management in April 2004. The Fund's true assets under management at the time, if any, were a fraction of that amount.

30. Respondent made some of the false and misleading marketing materials described in paragraphs 1 through 29 above available to investors through an internet site that he established for the purpose of soliciting investors.

E. RESPONDENT MADE MATERIAL MISREPRESENTATIONS CONCERNING THE NATURE OF THE FUND'S INVESTMENTS

31. Respondent (or Marketer A, acting at Respondent's direction) provided potential investors with a document that summarized the Fund's fourteen "layers of risk control" and emphasized the consistent performance of the "fund" during both bull and bear markets. The document stated, among other things, that "only low-risk or risk-adverse strategies are employed" and that there was "no single position having more than a 5% effect on the portfolio's return."

32. In March 2005, Respondent invested $500,000 of the Fund's assets in a newly-formed, private company named Insured Development Equity Advisors LLC ("IDEA") through execution of a promissory note payable to "Atlantis Capital Group." Atlantis Capital Group was a name used by Respondent to refer to all of the entities he operated.

33. At the time it was made, the amount of the IDEA investment exceeded 10% of the net asset value of the Fund.

34. The IDEA investment was inconsistent with the Due Diligence Report. Both versions of the report stated that all investments were in liquid, listed issues and could be exited at "the click of a mouse," and that "[b]ecause only listed securities are traded, there is virtually no counter party credit risk."

35. The Due Diligence Report further stated that "[n]either the fund management nor the basic investment strategy (in place for nearly eight years) is expected to change," and that if and when any such change occurred, investors would be given "advance written notice and an opportunity to reduce or withdraw their investment within 30 days." Despite this assurance, Respondent did not provide written notice to investors before making the IDEA investment, even though the investment was inconsistent with several aspects of the Fund's advertised strategy, including its "risk-averse" investment approach, its limitation on the size of individual positions, and its focus on listed, liquid securities.

F. RESPONDENT FAILED TO DISCLOSE SIGNIFICANT CONFLICTS OF INTEREST CONCERNING HIS INVESTMENT DECISIONS FOR THE FUND

36. In late 2004 and 2005, Respondent (or Marketer A, acting at Respondent's direction) represented to potential investors through the Due Diligence

Report that there were no "conflicts of interest by any owner, principal, manager or advisor of [the] fund not disclosed in [the] subscription documents."

37. Respondent did not make the IDEA investment because he believed it was in the Fund's interest. He made the investment because he expected that IDEA would hire him and/or his defunct broker-dealer, ACM Securities, to provide "asset management" services, as he admitted in an email dated December 28, 2006.

38. In March and April 2005, Respondent personally received $40,000 from IDEA. Respondent had done little or no work for IDEA at the time the payments were made, and the payments were not made pursuant to a written agreement setting forth the anticipated goods or services for which he received them.

39. Respondent's acceptance of the IDEA payment and expectation of financial benefits if IDEA became operational made it impossible for him to fairly evaluate the risky IDEA investment.

40. From at least May 2005 through at least September 2006, Respondent also received rebates on brokerage commissions, or similar undisclosed compensation, from many of the broker-dealers at which he traded the Fund's other assets. The compensation from each broker-dealer was based on the aggregate volume of trading in all accounts managed by Respondent at that broker-dealer, including both the Fund accounts and other accounts that Respondent traded.

41. From 2005 through September 2006, Respondent accepted undisclosed volume-based compensation totaling at least $400,000.

42. In approximately June 2005, Respondent updated the Due Diligence Report, in which he had previously represented that there were no undisclosed conflicts of interest. Despite the significant conflicts of interest presented by his compensation from IDEA and his receipt of volume-based compensation in connection with the Fund's trading, Respondent continued to represent that the Fund's advisers had no undisclosed conflicts of interest.

43. Respondent's conflicts of interest were material to investors, because they called into question Respondent's ability to fairly evaluate potential transactions on behalf of the Fund.

G. RESPONDENT USED THE FUND'S ASSETS AS COLLATERAL FOR HIS PERSONAL TRADING

44. In 2005 and 2006, Respondent established accounts for the Fund at several broker-dealers. Some of the broker-dealers were set up as limited liability companies, referred to in the industry as "proprietary trading firms," in which the Fund participated as a member rather than as a "customer." In these limited liability companies (the "LLCs"), all assets deposited became assets of the firm, and the depositor's "capital contribution" was placed in a sub-account of the firm's account with its clearing broker. At the LLCs, the members effectively pooled their capital for purposes of meeting margin

requirements. Respondent signed agreements with each LLC on behalf of the Fund and deposited Fund assets into sub-accounts set up for the Fund.

45. Without executing a separate agreement in the name of Respondent or another entity, Respondent set up additional member sub-accounts at the same LLCs in which the Fund's assets were held. Respondent traded his and his family's assets in these additional sub-accounts (the "Personal Accounts"), which were established in the name of Atlantis Capital Markets NA, LLC, Atlantis Capital Markets Securities, or other entities owned and controlled by Respondent.

46. Respondent explicitly agreed in writing with at least one of the LLCs ("Firm A") that the Fund's sub-account could be "cross margined" with Respondent's Personal Accounts. This meant that the Fund's assets would be considered in determining how much Respondent could borrow from the proprietary trading firm to support his securities transactions. It also meant that the assets in the Fund's sub-account could be used to cover margin calls issued with respect to the Personal Accounts.

47. In August 2006, the Fund suffered trading losses of approximately 29%. In September 2006, the Fund suffered additional losses.

48. In September 2006, the Fund's fund administrator concluded that the IDEA investment, which previously had been carried on the Fund's books at the face value of the promissory note, should be written down to zero.

49. In August and September 2006, Respondent also experienced trading losses in his Personal Accounts, which resulted in significant negative balances in his accounts at two proprietary trading firms. In September 2006, a second proprietary trading firm ("Firm B") transferred approximately $970,000 from the Fund's sub-account to offset the negative balance in Respondent's Personal Accounts.

50. The fund administrator calculated that these September events resulted in an additional 57% decrease in the value of the Fund.

51. In September 2006, after learning of the August and early September 2006 losses, most of the Fund's domestic investors requested redemptions of their interests in the Fund.

52. In September 2006, the fund administrator resigned. Respondent and his accountant assumed responsibility for calculating and paying redemptions.

53. On September 26, 2006, Respondent received notice that at the end of October, Firm A intended to "reflect the offset we have in our books" in the Fund sub-account and one of the Personal Accounts. Respondent was advised that "[t]his gives you until the end of October for capital to come in to clean this up before we go ahead and do the journal entry."

54. In October 2006, Firm A transferred approximately $1.8 million from the Fund's sub-account to offset the negative balance in Respondent's Personal Accounts.

55. Respondent knew that assets had been transferred from the Fund's accounts to cover his personal losses, but he did not disclose this material fact to each of the Fund's investors.

56. From October 2006 through March 2007, while the Fund's accountant was calculating the assets remaining in the Fund for the purpose of paying redemptions, Respondent advised investors that their redemptions were delayed because of an arbitration against the Fund's broker-dealer. Respondent failed to disclose to each investor that the arbitration involved the use of Fund assets to cover losses in his Personal Accounts at Firm B.

H. RESPONDENT BLATANTLY MISAPPROPRIATED ASSETS

57. In July 2006, Respondent registered a limited liability company named Pacific Capital Markets LLC in the State of Delaware. He also had drafted, and shared with a potential Australian investor, an offering memorandum for a fund named Pacific Capital Markets Cayman LDC ("Pacific"), a Cayman Islands exempted limited duration company. The documents reflected that a long-time friend of Respondent who had helped to market Atlantis ("Marketer B"), was to share responsibility with Respondent for managing the new fund and trading its investments.

58. In November 2006 and February 2007, before redemptions had been made to all of those Fund investors who had requested them, Respondent transferred over $850,000 from the Fund's bank accounts to a bank account in the name of Pacific Capital Markets, L.P.

59. Respondent also used the Fund's assets to pay substantial compensation to himself and his business partner, Marketer B, before the redemptions were made.

60. From September 2006 through March 2007, Respondent wrote $74,000 in checks from the Fund's bank account to himself, to cash, and to entities he controlled. Respondent knew, or was reckless in not knowing, that these payments were not authorized by the Fund's offering documents, because they significantly exceeded the management fee that he earned during that period, and the offering documents provided no other basis on which he could withdraw money from the Fund during a period in which it had experienced significant losses.

61. From September 2006 through March 2007, Respondent wrote $22,500 in checks from the Fund's bank account to Marketer B. These payments were made in exchange for Marketer B's promise to obtain $20 million in capital for Respondent's new hedge fund, Pacific Capital Markets. Respondent knew, or was reckless in not knowing, that the Fund's offering documents did not authorize the use of Fund assets to solicit investors for other hedge funds.

62. In February and March 2007, the investors who had requested redemptions in September 2006 received redemptions in the amount of approximately 10% of their accounts' values as of July 31, 2006. Respondent failed to provide any audit or other accounting to investors to explain the significant reduction in the value of their accounts.

63. Respondent failed to disclose to the redeeming investors the material fact that their redemptions had been reduced by Respondent's unauthorized payments to himself and Marketer B. Respondent also failed to disclose to each of the redeeming investors that their redemptions had been reduced by the amount of the LLCs' transfers to cover losses in Respondent's Personal Accounts.

64. Some investors did not seek redemptions in September 2006. From October 2006 to at least March 2007, Respondent provided false monthly statements to these investors. Respondent reported to one institutional investor that the monthly return for its investment in September 2006 was zero percent. In fact, as Respondent knew, the Fund lost approximately 57% in September 2006 and lost additional amounts in subsequent months. Two investors requested redemption later, in December 2007, but to date have not received any portion of their investment.

I. RESPONDENT CONTINUES TO SOLICIT CAPITAL BASED ON FALSE INFORMATION

65. From approximately September 2007 to December 13, 2010, Respondent provided materially misleading information and marketing materials to a third-party hedge fund information provider ("Hedge Fund Information Provider B") concerning the history and performance results of Pacific.

66. Respondent initially marketed Pacific under the name "Pacific Capital Markets Preservation of Capital Plus" and provided marketing materials to Hedge Fund Information Provider B stating that the "centerpiece of the program is the Collateralized Guaranteed Real Estate Note Program."

67. The marketing materials claimed that Pacific has "never had a negative month" since its inception in June 2002. In fact, as Respondent knew, Pacific did not exist until 2006.

68. In September 2007, Respondent informed Hedge Fund Information Provider B that Pacific had assets under management of $701 million onshore and $107 million offshore. Respondent knew that Hedge Fund Information Provider B would provide that information to potential investors. In fact, as Respondent knew, the only assets in Pacific at that time were the remainder of the approximately $850,000 that Respondent had transferred from the Fund to Pacific in November 2006 and February 2007.

69. In July 2009, Respondent began to market Pacific under the name "Pacific Capital Markets Preservation of Capital Absolute Alpha No Beta," and he updated

its marketing materials to reflect that the fund was engaged in the facilitation of private energy trades.

70. On September 29, 2010, Respondent provided updated marketing materials to Hedge Fund Information Provider B that hid his true identity and instead held himself out as an individual named "John RWL Adams." In October 2010, Respondent changed the name under which his mobile phone was registered to "John Adams."

71. In November 2010, Respondent instructed Hedge Fund Information Provider B to change Pacific's name to "Pacific Capital Markets Cayman LDC Absolute Alpha No Beta" and represented that it managed assets of 100 million dollars. Respondent knew that Hedge Fund Information Provider B would provide that information to potential investors. In fact, as Respondent knew, no investor contributions had been made to Pacific.

J. RESPONDENT FABRICATED EXCULPATORY EVIDENCE

72. In October 2010, Respondent received a validly issued investigative subpoena (the "Subpoena") that called for all documents relating to the Fund for the time period January 1, 2004 through the present, among other things.

73. On October 29, 2010, Respondent produced documents to the Division staff in response to the Subpoena.

74. At approximately the same time, Division staff received several similar versions of the Due Diligence Report described above from several investors in the Fund (the "Original Report"). The document appeared to be one that Lyniuk provided to prospective investors in late 2004 and 2005.

75. Respondent never produced a copy of the Original Report – or any similar document – to the Division staff in response to the Subpoena.

76. On December 8 and 10, 2010, Respondent appeared for testimony before the Division staff. On December 10, 2010, the staff marked as an exhibit a version of the Original Report that was dated December 2004. The staff questioned Respondent about the exhibit, in particular certain representations that appeared to be false or misleading.

77. On January 14, 2011, the Division staff sent a Wells notice to Respondent. The notice advised Respondent that the Division intended to recommend charges against him. It further invited him to make a submission to the Commission explaining any reasons the Commission should not subject him to legal action. Respondent retained counsel shortly thereafter. The Division staff orally advised Respondent's counsel that it had concerns about certain representations in the Original Report.

78. On January 31, 2011, Respondent's counsel made a Wells submission on Respondent's behalf. Respondent's counsel attached an exculpatory version of the Due Diligence Report that neither Respondent nor any investor had ever produced to the staff (the "Exculpatory Report"). It differed materially from the Original Report in

certain respects. For example, the Exculpatory Report deleted a chart of purported historical returns that had been in the Original Report, it eliminated the Original Report's claims about historical assets under management, and it deleted references to the Fund's eight-year track record. The Division forwarded the Wells submission and attachments to the Commission.

79. On or about February 23, 2011, the United States District Court for the District of New Jersey issued a warrant for a search of Respondent's home for computers and electronic storage media, among other things.

80. On or about March 1, 2011, the Federal Bureau of Investigation ("FBI") executed the search warrant. The FBI seized an external storage device from Respondent's house containing at least one version of the Original Report and one version of the Exculpatory Report. Information on the seized storage device shows that Respondent created and/or modified the Exculpatory Report on December 12, 2010, just two days after Division staff questioned Respondent about potential misrepresentations in the Original Report.

81. Respondent appears to have fabricated the Exculpatory Report and presented it to the Commission in his Wells submission in an attempt to exculpate himself.

K. VIOLATIONS

82. The misstatements and omissions of fact alleged in this Order were material.

83. Respondent knew, or was reckless in not knowing, that his statements (and those of Marketer A, acting at his direction) were false and misleading.

84. As a result of the conduct described above, Respondent willfully violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in the offer and sale of securities and in connection with the purchase or sale of securities.

85. As a result of the conduct described above, Respondent willfully violated Sections 206(1) and 206(2) of the Advisers Act, which prohibit fraudulent conduct by an investment adviser with respect to its clients.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate in the public interest that public administrative and cease-and-desist proceedings be instituted to determine:

A. Whether the allegations set forth in Section II hereof are true and, in connection therewith, to afford Respondent an opportunity to establish any defenses to such allegations;

B. What, if any, remedial action is appropriate in the public interest against Respondent pursuant to Section 15(b) of the Exchange Act including, but not limited to, disgorgement and civil penalties pursuant to Section 21B of the Exchange Act;

C. What, if any, remedial action is appropriate in the public interest against Respondent pursuant to Section 203(f) of the Advisers Act including, but not limited to, disgorgement pursuant to Section 203(j) and civil penalties pursuant to Section 203(i) of the Advisers Act;

D. What, if any, remedial action is appropriate and in the public interest against Respondent pursuant to Section 9(b) of the Investment Company Act, including, but not limited to, disgorgement pursuant to Section 9(e) and civil penalties pursuant to Section 9(d) of the Investment Company Act;

E. Whether, pursuant to Section 8A of the Securities Act, Section 21C of the Exchange Act, and Section 203(k) of the Advisers Act, Respondent should be ordered to cease and desist from committing or causing violations of and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1) and (2) of the Advisers Act and whether Respondent should be ordered to pay disgorgement plus prejudgment interest thereon and provide an accounting pursuant to Section 8A(e) of the Securities Act, Section 21C(e) of the Exchange Act, and Section 203(k) of the Advisers Act.

IV.

IT IS ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened not earlier than 30 days and not later than 60 days from service of this Order at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice, 17 C.F.R. § 201.110.

IT IS FURTHER ORDERED that Respondent shall file an Answer to the allegations contained in this Order within twenty (20) days after service of this Order, as provided by Rule 220 of the Commission's Rules of Practice, 17 C.F.R. § 201.220.

If Respondent fails to file the directed answer, or fails to appear at a hearing after being duly notified, the Respondent may be deemed in default and the proceedings may be determined against him upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f) and 310 of the Commission's Rules of Practice, 17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f) and 201.310.

This Order shall be served forthwith upon Respondent personally or by certified mail.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 300 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice.

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Chairman Schapiro
Commissioner Walter
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64123 / March 24, 2011

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3255 / March 24, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14305

In the Matter of	**ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, IMPOSING A CEASE-AND-DESIST ORDER AND A CIVIL MONEY PENALTY**
BALL CORPORATION,	
Respondent.	

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Ball Corporation ("Ball," "the Company," or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over Respondent and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order and a Civil Money Penalty ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

Summary

1. Ball Corporation, an Indiana corporation based in Broomfield Colorado, is a manufacturer of metal packaging for beverages, foods and household products. From July 2006 through October 2007, Ball, through its Argentine subsidiary Formametal, S.A., offered and paid at least ten bribes, totaling at least $106,749, to employees of the Argentine government to secure the importation of prohibited used machinery and the exportation of raw materials at reduced tariffs.

2. Although certain accounting personnel at Ball learned soon after Ball acquired Formametal in March 2006 that Formametal employees may have made questionable payments and caused other compliance problems before the acquisition, the Company failed to take sufficient action to ensure that such activities did not recur at Formametal after Ball took control of the Argentine company. Within months of Ball's acquisition of Formametal, two Formametal executives—the then-Formametal President and then-Formametal Vice President of Institutional Affairs (hereinafter the "President" and "Vice President of Institutional Affairs," respectively)—authorized improper payments to Argentine officials. The true nature of the payments was mischaracterized as ordinary business expenses on Formametal's books and records and went undetected for over a year.

Respondent

3. In addition to supplying metal cans to food, beverage, and household products customers, Ball Corporation provides aerospace and other technological services to commercial and governmental customers. The Company employs approximately 14,000 people in more than ninety locations worldwide. Its stock is registered pursuant to Section 12(b) of the Exchange Act and is listed on the New York Stock Exchange under the ticker symbol BLL. Ball's Form 10-K for the period ending December 31, 2009, reported consolidated net income of $387.9 million on revenue of $7.34 billion. Ball acquired Argentine company Formametal, S.A., on March 27, 2006, as part of an acquisition of a larger U.S. aerosol container business. Formametal, a wholly-owned subsidiary of Ball, manufactures aerosol cans. Formametal's financial results are reported on a consolidated basis in Ball's financial statements.

Facts

A. Formametal Made or Offered Unlawful Payments to Officials of the Argentine Government

4. In June 2006, approximately three months after Ball acquired Formametal, a financial analyst in the general accounting group for Ball's Metal Food and Household Packaging Products Division made a routine visit to the newly acquired subsidiary to gather information about its operations. During the course of his visit, the analyst discovered that Formametal's employees may have made questionable payments and caused other compliance problems in the past. Concerned that such activity could recur at Formametal in the future, the analyst included his findings in a report ("the Formametal Report") that he submitted to the director of accounting of Ball's Metal Food and Household Packaging Products Division. The Formametal Report highlighted prior infractions by Formametal, including questionable customs fees, used machinery being declared new to circumvent customs regulations, other dishonest customs declarations, and the destruction of documents. Although Ball had demoted Formametal's incumbent President and replaced the Chief Financial Officer after acquiring the subsidiary in March 2006, when the Formametal Report came to the attention of several senior executives in Ball's Metal Food and Household Packaging Products Division, Ball's actions were not sufficient to prevent future infractions by Formametal executives.

5. In the period between July 2006 and October 2007, and following the analyst's discoveries, Formametal's senior officers authorized at least ten unlawful payments totaling approximately $106,749 to Argentine government officials. Some payments were specifically authorized by Formametal's President, while in other instances, he appeared to have been aware that the unlawful payments were occurring and acquiesced to them. In some instances, the President learned about the opportunity to make a bribe from the Vice President of Institutional Affairs, who would then make the arrangements for the bribe without providing details to the President. These payments were disguised to appear as legitimate business expenses in Formametal's books and records and included in Ball's consolidated financial results reported for fiscal year 2006 and the first three quarters of 2007. These improper payments are explained below.

B. Equipment Import

6. Formametal paid bribes totaling over $100,000 in 2006 and 2007 to secure the importation of equipment for use in its manufacturing process. Formametal's President authorized at least two of these payments. In most cases, the bribes were paid to induce government customs officials to circumvent Argentine laws prohibiting the importation of used equipment and parts. The bribes often appeared on invoices from a non-governmental customs agent for Formametal. The payments were invoiced as separate line items described inaccurately as "fees for customs assistance," "customs advisory services," "verification charge," or simply "fees," were invoiced in addition to other customs-related fees, and were sometimes in rounded peso amounts. To further obscure that the payments were really bribes, Formametal posted the payments

inaccurately identified as "customs advice" or "professional fees" to an "Other Expenses" account or in some instances to an account named for the related equipment.

C. Copper Scrap Export Waiver

7. Formametal paid a bribe that its President authorized in October 2007 in an attempt to bypass high government duties imposed on copper scrap exports. These duties, which were generally 40 percent of the value of the copper, were imposed by Argentina in an effort to discourage export sales of domestically produced copper and copper scraps. The President estimated the additional profit from exporting this copper scrap with the export duty waivers versus selling it inside Argentina would be approximately $1.5 million annually.

8. For six months prior to August 2007, Formametal unsuccessfully sought to gain government approval to export the scrap without the customarily high duties. After giving up on obtaining the waiver legitimately, on October 18, 2007, Formametal disbursed $4,821, representing the first of five bribe installments authorized by its President to obtain an export duty waiver. The payment was funneled through Formametal's third party customs agent. Obscuring that the transaction was a bribe, Formametal inaccurately recorded the payment as "Advice fees for temporary merchandise exported" in an "Other Expenses" account. Although the President believed that the payments were requested by a customs official and would result in a copper scrap export duty waiver, no copper scrap export shipments were made pursuant to the improper payment.

D. Ball Accountants Learn About One Bribe

9. As early as February 2007, two accountants in Ball's Metal Food and Household Packaging Products Division learned about one of the bribes paid by Formametal to import machinery for use in its manufacturing process. Formametal's Vice President of Institutional Affairs, an Argentine national, who was formerly president and owner of the subsidiary, had paid the bribe on behalf of Formametal out of his own funds and received reimbursement from Formametal in the form of a company car. Formametal initially booked the transfer of the car as an interest expense. After being pressed for details about the transaction, Formametal's President revealed to the two Ball accountants that the car was reimbursement for a bribe paid by the Vice President of Institutional Affairs. Although Formametal subsequently changed the accounting to record the transfer of the car as a miscellaneous expense, it still failed to accurately describe the "transfer" as a reimbursement for an illegal payment made to Argentine customs officials.

E. Ball Failed to Establish Sufficient Internal Accounting Controls

10. Ball's and Formametal's weak internal controls, which included importing equipment into Argentina in 2006 and 2007 without appropriate invoices and documentation, made it difficult to detect that the subsidiary was repeatedly violating Argentine law through the payment of bribes. Ball's weak internal controls also factored into the Company's failure to prevent further abuses at Formametal, after Ball accountants learned of a bribe paid by Formametal to import machinery for use in its manufacturing process. As a result, Formametal continued to make improper payments during 2007.

11. Further, Ball lacked sufficient internal controls to bring about effective changes after information available to Ball's executives indicated anti-bribery compliance problems at Formametal. For example, key personnel responsible for dealing with customs officials remained at Formametal, even though external due diligence performed on Formametal suggested that Formametal officials may have previously authorized questionable payments.

Legal Analysis

12. The FCPA, enacted in 1977, added Exchange Act Section 13(b)(2)(A) to require public companies to make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer. It also added Exchange Act Section 13(b)(2)(B) to require such companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions: (i) are executed in accordance with management's general or specific authorization; and (ii) are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and to maintain accountability for assets. 15 U.S.C. §§ 78m(b)(2)(A) and 78m(b)(2)(B).

13. As detailed above, Formametal failed to properly record illegal payments and transactions when it repeatedly paid bribes disguised as customs assistance on invoices from its customs agent. In addition, Formametal used a customs agent as an intermediary to obscure the source and destination of funds, and it created false or misleading journal entries to facilitate the illegal importation of used machinery into Argentina. Ultimately, the improper payments, as well as the book value of the car given as reimbursement for a bribe paid by Formametal's Vice President of Institutional Affairs were mischaracterized as ordinary business expenses on Formametal's books and records. Because Formametal's financial statements were consolidated with those of Ball, Ball failed to keep accurate books and records in violation of Exchange Act Section 13(b)(2)(A).

14. In violation of Exchange Act Section 13(b)(2)(B), Ball also failed to devise and maintain an effective system of internal controls to prevent and detect violations of the FCPA at Formametal, even after senior Ball officers were on notice in

mid-2006 that in the past Ball's subsidiary's employees had made questionable payments and caused other compliance problems.

Ball's Remedial Efforts and Cooperation

15. In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondent, Respondent's voluntary disclosure of these matters to the Commission, and cooperation afforded the Commission staff.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent Ball's Offer.

Accordingly, it is hereby ORDERED that:

(A) Pursuant to Section 21C of the Exchange Act, Respondent Ball cease and desist from committing or causing any violations and any future violations of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act;

(B) Respondent shall, within fifteen (15) days of the entry of this Order, pay the civil penalty of $300,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Such payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Ball Corporation as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Gerald W. Hodgkins, Associate Director, Division of Enforcement, Securities and Exchange Commission, 100 F Street, N.E., Washington, D.C. 20549-6010.

(C) Respondent acknowledges that the Commission is not imposing a civil penalty in excess of $300,000 based upon its cooperation in a Commission investigation and related enforcement action. If at any time following the entry of the Order, the Division of Enforcement ("Division") obtains information indicating that Respondent knowingly provided materially false or misleading information or materials to the Commission or in a related proceeding, the Division may, at its sole discretion and without prior notice to the Respondent, petition the Commission to reopen this matter and seek an order directing that the Respondent pay an additional civil penalty. Respondent may not, by way of defense to any resulting administrative proceeding: (1) contest the findings in the Order; or (2) assert any defense to liability or remedy, including, but not limited to, any statute of limitations defense.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Chairman Schapiro
Commissioner Aguilar
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64126 / March 25, 2011

INVESTMENT ADVISERS ACT OF 1940
Release No. 3180 / March 25, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14309

In the Matter of

JOSEPH A. DAWSON,

Respondent.

ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Joseph A. Dawson ("Dawson" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Section III.2 and III.4 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to

Section 15(b) of the Securities Exchange Act of 1934 and Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. Dawson, age 49, is a resident of Fox Lake, Illinois. He was the owner and president of Dawson Trading, LLC, an unregistered broker-dealer entity. From October 2004 through 2009, Dawson acted as an unregistered investment adviser to Dawson Trading, soliciting investors to invest in promissory notes issued by Dawson Trading, providing investment advice to Dawson Trading, making investment decisions on behalf of Dawson Trading, and effecting transactions in securities for Dawson Trading. Dawson was registered with the NASD as a registered representative while he was employed with an Illinois-based broker-dealer, Shepherd Financial Group, Inc. from 1995 to 1996.

2. On March 17, 2011, a final judgment was entered by consent against Dawson, permanently enjoining him from future violations of Sections 5(a), 5(c), and 17(a) of the Securities Act of 1933, Sections 10(b) and 15(a) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1), 206(2), and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder in the civil action entitled Securities and Exchange Commission v. Joseph A. Dawson, Civil Action Number 1:11-cv-01615, in the United States District Court for the Northern District of Illinois.

3. The Commission's complaint alleged that Dawson engaged in a fraudulent offering scheme and unlawful insider trading. The complaint alleged that during an approximately five-year period, Dawson raised approximately $3.8 million from approximately 31 investors through the sale of promissory notes that provided guaranteed returns. The complaint further alleged that instead of investing the $3.8 million on behalf of investors, Dawson misappropriated approximately $2.1 million for his own personal expenses and purposes, and lost $945,000 trading securities. The complaint alleged that despite having never invested or losing the funds that were invested, Dawson provided false quarterly account statements to investors which showed significant returns. The complaint also alleged that through Dawson Trading, Dawson also engaged in unlawful insider trading by purchasing options of SPSS Inc. based on material, non-public information in advance of the July 28, 2009 announcement that International Business Machines Corporation was going to acquire SPSS. The complaint alleged that the unlawful trading generated profits of approximately $437,770.

4. On November 18, 2010, Dawson pled guilty to three counts of wire fraud (18 U.S.C. § 1343) before the United States District Court for the Northern District of Illinois in United States v. Joseph A. Dawson, Criminal Action No. 1:09-cr-01037-1. Dawson was sentenced on March 8, 2011 to 54 months in prison.

5. The counts of the criminal information to which Dawson pled guilty alleged, among other things, that Dawson defrauded investors and obtained money from investors

by means of materially false and misleading statements, and that he caused investor funds to be transmitted by interstate wire to Dawson Trading and that these funds represented clients' investments in Dawson Trading.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Dawson's Offer.

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b)(6) of the Exchange Act and Section 203(f) of the Advisers Act, that Respondent Dawson be, and hereby is barred from association with any broker, dealer, or investment adviser, municipal securities dealer, or transfer agent.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

Respondent be, and hereby is, barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64135 / March 28, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14311

In the Matter of Sporlox Corp., Respondent.	ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondent Sporlox Corp.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENT

1. Sporlox Corp. (CIK No. 1138243) is a permanently revoked Nevada corporation located in San Antonio de Belen, Heredia, Costa Rica with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Sporlox is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-SB/A registration statement on May 31, 2001, which reported a net loss of $3,000 for the year ended February 28, 2001.

B. DELINQUENT PERIODIC FILINGS

2. As discussed in more detail above, the Respondent is delinquent in its periodic filings with the Commission, has repeatedly failed to meet its obligations to file timely periodic reports, and failed to heed a delinquency letter sent to it by the Division of Corporation Finance requesting compliance with its periodic filing obligations or,

through its failure to maintain a valid address on file with the Commission as required by Commission rules, did not receive such letter.

3. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers of securities registered pursuant to Exchange Act Section 12 to file with the Commission current and accurate information in periodic reports, even if the registration is voluntary under Section 12(g). Specifically, Rule 13a-1 requires issuers to file annual reports, and Rule 13a-13 requires issuers to file quarterly reports.

4. As a result of the foregoing, Respondent failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate for the protection of investors that public administrative proceedings be instituted to determine:

A. Whether the allegations contained in Section II hereof are true and, in connection therewith, to afford the Respondent an opportunity to establish any defenses to such allegations; and,

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or revoke the registration of each class of securities registered pursuant to Section 12 of the Exchange Act of the Respondent identified in Section II hereof, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of the Respondent.

IV.

IT IS HEREBY ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice [17 C.F.R. § 201.110].

IT IS HEREBY FURTHER ORDERED that Respondent shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220(b) of the Commission's Rules of Practice [17 C.F.R. § 201.220(b)].

If Respondent fails to file the directed Answer, or fails to appear at a hearing after being duly notified, the Respondent, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of the Respondent, may be deemed in default and the proceedings may be determined against it upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondent personally or by certified, registered, or Express Mail, or by other means permitted by the Commission Rules of Practice.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 120 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice [17 C.F.R. § 201.360(a)(2)].

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64139 / March 28, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14312

In the Matter of **Clarion Internet, Inc.,** **The Clarke Corp.,** **Clement Corp.,** **Cochstedt International Airport, Inc.,** **Coded Communications Corp.,** **Collaborative Financial Network Group, Inc.,** **Commercial International Corp., and** **Convergent Communications, Inc.,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents Clarion Internet, Inc., The Clarke Corp., Clement Corp., Cochstedt International Airport, Inc., Coded Communications Corp., Collaborative Financial Network Group, Inc., Commercial International Corp., and Convergent Communications, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Clarion Internet, Inc. (CIK No. 1083962) is a revoked Nevada corporation located in Palm Desert, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Clarion Internet is delinquent in

its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended June 30, 2001, which reported a net loss of over $1,000 for the prior six months.

2. The Clarke Corp. (CIK No. 20784) is a Pennsylvania corporation located in La Habra, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Clarke is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-K for the period ended December 31, 1996.

3. Clement Corp. (CIK No. 1140874) is a Nevada corporation located in Capistrano Beach, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Clement is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2002, which reported a net loss of $500 for the prior three months.

4. Cochstedt International Airport, Inc. (CIK No. 1098377) is a permanently revoked Nevada corporation located in Las Vegas, Nevada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Cochstedt is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2000, which reported a net loss of $826 for the prior three months.

5. Coded Communications Corp. (CIK No. 847931) is a void Delaware corporation located in Carlsbad, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Coded Communications is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended October 3, 1998, which reported a net loss of over $4 million for the prior nine months. On December 10, 1998, Coded Communications filed a Chapter 11 petition in the U.S. Bankruptcy Court for the District of Delaware, which was converted to Chapter 7, and was terminated on September 24, 2007.

6. Collaborative Financial Network Group, Inc. (CIK No. 1092310) is a void Delaware corporation located in Century City, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Collaborative Financial Network Group is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB/A for the period ended June 30, 2001, which reported a net loss of over $419,000 for the prior nine months.

7. Commercial International Corp. (CIK No. 22428) is a Delaware corporation located in Los Angeles, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Commercial International is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended November 30, 1992, which reported a net loss of over $316,000 for the prior six months.

8. Convergent Communications, Inc. (CIK No. 1046558) is a dissolved Colorado corporation located in Englewood, Colorado with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Convergent Communications is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 2000, which reported a net loss of over $69 million for the prior nine months. On April 19, 2001, Convergent Communications filed a Chapter 11 petition in the U.S. Bankruptcy Court for the District of Colorado, which was terminated on February 15, 2008.

B. DELINQUENT PERIODIC FILINGS

9. As discussed in more detail above, all of the Respondents are delinquent in their periodic filings with the Commission, have repeatedly failed to meet their obligations to file timely periodic reports, and failed to heed delinquency letters sent to them by the Division of Corporation Finance requesting compliance with their periodic filing obligations or, through their failure to maintain a valid address on file with the Commission as required by Commission rules, did not receive such letters.

10. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers of securities registered pursuant to Exchange Act Section 12 to file with the Commission current and accurate information in periodic reports, even if the registration is voluntary under Section 12(g). Specifically, Rule 13a-1 requires issuers to file annual reports, and Rule 13a-13 requires domestic issuers to file quarterly reports.

11. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate for the protection of investors that public administrative proceedings be instituted to determine:

A. Whether the allegations contained in Section II hereof are true and, in connection therewith, to afford the Respondents an opportunity to establish any defenses to such allegations; and,

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or revoke the registration of each class of securities registered pursuant to Section 12 of the Exchange Act of the Respondents identified in Section II hereof, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents.

IV.

IT IS HEREBY ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice [17 C.F.R. § 201.110].

IT IS HEREBY FURTHER ORDERED that Respondents shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220(b) of the Commission's Rules of Practice [17 C.F.R. § 201.220(b)].

If Respondents fail to file the directed Answers, or fail to appear at a hearing after being duly notified, the Respondents, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents, may be deemed in default and the proceedings may be determined against it upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means permitted by the Commission Rules of Practice.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 120 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice [17 C.F.R. § 201.360(a)(2)].

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Chairman Schapiro not participating

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 64145 / March 29, 2011

Admin. Proc. File No. 3-14174

In the Matter of the Application of THOMAS PRESTON OSBORN For Review of Action Taken by FINRA	ORDER DISMISSING PETITION FOR REVIEW

On January 3, 2011, Thomas Preston Osborn, formerly a registered representative associated with Wells Fargo Advisors, LLC ("Wells Fargo"), a FINRA member firm, filed an application for review of FINRA disciplinary action. FINRA barred Osborn pursuant to FINRA Rule 9552[1] for failing to respond to a request to provide information pursuant to Rule 8210[2] in connection with his termination from Wells Fargo. In his application for review, Osborn asked that the Commission set aside the bar. Osborn explained that, because of a family court dispute, he had been incarcerated and therefore did not receive FINRA's information requests or the subsequent suspension notices that resulted in his bar.

On February 3, 2011, FINRA filed a "Motion to Dismiss Thomas Preston Osborn's Application for Review and to Stay Briefing Schedule" with the Commission. In its motion, FINRA states that Osborn's application for review included information "responsive to FINRA's information requests." FINRA explains that, as a result of "Osborn's willingness to respond to FINRA's request for information and the extraordinary circumstances that made him unavailable," Osborn and FINRA entered into a Letter of Acceptance, Waiver, and Consent, in which Osborn agreed to settle the matter for a sanction less than a bar. FINRA accordingly

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1 FINRA Rule 9552 provides that FINRA may suspend a person subject to FINRA's jurisdiction who fails to provide information and that, if the person subsequently fails to request termination of the suspension within three months, that person will be automatically barred.

2 FINRA Rule 8210 requires persons associated (or formerly associated) with a member firm to provide information with respect to any matter involved in an investigation, complaint, or proceeding.

asserts that Osborn's application for review is now moot and requests that the Commission dismiss Osborn's application for review.[3] Osborn has not filed an opposition to FINRA's motion, and FINRA states that "[c]ounsel for FINRA has spoken with Osborn and he does not oppose FINRA's motion." Under these circumstances, we find it appropriate to grant FINRA's motion and dismiss Osborn's Application for Review.

Accordingly, it is ORDERED that Thomas Preston Osborn's Application for Review be, and it hereby is, dismissed.

By the Commission.

Sincerely,

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

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[3] On February 14, 2011, the Commission, by the Secretary pursuant to delegated authority, granted FINRA's request to stay briefing in the matter by ordering that the briefing schedule be extended until the Commission ruled on FINRA's motion to dismiss.

SECURITIES AND EXCHANGE COMMISSION

17 CFR PARTS 229 and 240

[RELEASE NOS. 33-9199; 34-64149; File No. S7-13-11]

RIN 3235-AK95

LISTING STANDARDS FOR COMPENSATION COMMITTEES

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: We are proposing a new rule and rule amendments to implement the provisions of Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which adds Section 10C to the Securities Exchange Act of 1934 (the "Exchange Act"). Section 10C requires the Commission to adopt rules directing the national securities exchanges (the "exchanges") and national securities associations to prohibit the listing of any equity security of an issuer that is not in compliance with Section 10C's compensation committee and compensation adviser requirements. In accordance with the statute, the proposed rule would direct the exchanges to establish listing standards that, among other things, require each member of a listed issuer's compensation committee to be a member of the board of directors and to be "independent," as defined in the listing standards of the exchanges adopted in accordance with the proposed rule. In addition, Section 10C(c)(2) of the Exchange Act requires the Commission to adopt new disclosure rules concerning the use of compensation consultants and conflicts of interest.

DATES: Comments should be received on or before April 29, 2011.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml);
- Send an e-mail to rule-comments@sec.gov; or
- Use the Federal Rulemaking ePortal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-13-11. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/proposed.shtml). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Nandini A. Acharya, Attorney-Adviser, or N. Sean Harrison, Special Counsel, at (202) 551-3430, in the Office of Rulemaking, Division of Corporation Finance, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-3628.

SUPPLEMENTARY INFORMATION: We are proposing to add new Rule 10C-1 under the Securities Exchange Act of 1934.[1] We are also proposing amendments to Item 407[2] of Regulation S-K.[3]

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[1] 15 U.S.C. 78a et seq.

[2] 17 CFR 229.407.

[3] 17 CFR 229.10 et seq.

I. BACKGROUND AND SUMMARY

We are proposing a new rule and rule amendments to implement the provisions of Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Act"),[4] which adds Section 10C to the Securities Exchange Act of 1934 (the "Exchange Act"). Section 10C requires the Commission to direct the national securities exchanges[5] (the "exchanges") and national securities associations[6] to prohibit the listing of any equity[7] security of

[4] Pub. L. No. 111-203, 124 Stat. 1900 (2010).

[5] A "national securities exchange" is an exchange registered as such under Section 6 of the Exchange Act [15 U.S.C. 78f]. There are currently fifteen national securities exchanges registered under Section 6(a) of the Exchange Act: NYSE Amex (formerly the American Stock Exchange), BATS Exchange, BATS Y-Exchange, NASDAQ OMX BX (formerly the Boston Stock Exchange), C2 Options Exchange, Chicago Board Options Exchange, Chicago Stock Exchange, EDGA Exchange, EDGX Exchange, International Securities Exchange, The NASDAQ Stock Market, National Stock Exchange, New York Stock Exchange, NYSE Arca and NASDAQ OMX PHLX (formerly Philadelphia Stock Exchange). Certain exchanges are registered with the Commission through a notice filing under Section 6(g) of the Exchange Act for the purpose of trading security futures. See Section II.B.1, below, for a discussion of these types of exchanges.

[6] A "national securities association" is an association of brokers and dealers registered as such under Section 15A of the Exchange Act [15 U.S.C. 78o-3]. The Financial Industry Regulatory Authority ("FINRA") is the only national securities association registered with the Commission under Section 15A(a) of the Exchange Act. Because FINRA does not list equity securities, we refer only to the exchanges in this release.

In addition, Section 15A(k) of the Exchange Act [15 U.S.C. 78o-3(k)] provides that a futures association registered under Section 17 of the Commodity Exchange Act [7 U.S.C. 21] shall be registered as a national securities an issuer, with certain exemptions, that does not comply with Section 10C's compensation committee and compensation adviser requirements.[8]

Specifically, Section 10C(a)(1) of the Exchange Act requires the Commission to adopt rules directing the exchanges to prohibit the listing of any equity security of an issuer, with certain exemptions, that is not in compliance with the independence requirements for members of the compensation committee of the board of directors of an issuer. In accordance with the statute, the rules, once adopted, would require the exchanges to establish listing standards that require each member of a listed issuer's compensation committee to be a member of the board of directors and to be "independent." The term "independent" is not defined in Section 10C(a)(1). Instead, the section provides that "independent" is to be defined by the exchanges after taking into consideration "relevant factors." As provided in Section 10C(a)(1), the "relevant factors" are required to include (1) the source of compensation of a member of the board of directors of an issuer, including any consulting, advisory, or other compensatory fee paid by the issuer to such member of the board of directors, and (2) whether a member of the board of directors of an issuer is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer. Section 10C(a)(4) of the Exchange Act requires our rules to permit the exchanges to exempt particular relationships from the independence requirements, as each exchange determines is appropriate, taking into consideration the size of an issuer and any other relevant factors.

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association for the limited purpose of regulating the activities of members who are registered as broker-dealers in security futures products pursuant to Section 15(b)(11) of the Exchange Act [15 U.S.C. 78o(b)(11)]. See Section II.B.2, below, for a discussion regarding security futures products.

[7] See Section II.B.2, below, for a discussion of the scope of Section 10C, including our conclusion that it does not apply to issuers with only listed debt securities. That section also proposes an exemption for securities futures products and standardized options, and clarifies that national securities and futures associations that do not list securities do not have to adopt specific rules in accordance with this rulemaking and Section 10C of the Exchange Act.

[8] See Exchange Act Sections 10C(a) and (f).

In addition to the independence requirements set forth in Section 10C(a), Section 10C(f) of the Exchange Act requires the Commission to adopt rules directing the exchanges to prohibit the listing of any security of an issuer that is not in compliance with the following requirements relating to compensation committees and compensation advisers, as set forth in paragraphs (b)-(e) of Section 10C:

- Each compensation committee must have the authority, in its sole discretion, to retain or obtain the advice of compensation consultants, independent legal counsel and other advisers (collectively, "compensation advisers");[9]
- Before selecting any compensation adviser, the compensation committee must take into consideration specific factors identified by the Commission that affect the independence of compensation advisers;[10]
- The compensation committee must be directly responsible for the appointment, compensation and oversight of the work of any compensation adviser;[11] and
- Each listed issuer must provide appropriate funding for the payment of reasonable compensation, as determined by the compensation committee, to compensation advisers.[12]

Finally, Section 10C(c)(2) requires each issuer to disclose in any proxy or consent solicitation material for an annual meeting of shareholders (or a special meeting in lieu of the annual meeting), in accordance with Commission regulations, whether the issuer's compensation committee retained or obtained the advice of a compensation consultant; whether the work of the

[9] Exchange Act Sections 10C(c)(1)(A) and 10C(d)(1).

[10] Exchange Act Section 10C(b).

[11] Exchange Act Sections 10C(c)(1)(B) and 10C(d)(2).

[12] Exchange Act Section 10C(e).

compensation consultant has raised any conflict of interest; and, if so, the nature of the conflict and how the conflict is being addressed.

We are proposing new Exchange Act Rule 10C-1 to implement the compensation committee listing requirements of Sections 10C(a)-(g)[13] of the Exchange Act. To implement Section 10C(c)(2) of the Exchange Act, we are proposing rule amendments to Regulation S-K to require disclosure, in any proxy or information statement relating to an annual meeting of shareholders at which directors are to be elected (or special meeting in lieu of the annual meeting), of whether the issuer's compensation committee retained or obtained the advice of a compensation consultant; whether the work of the compensation consultant has raised any conflict of interest; and, if so, the nature of the conflict and how the conflict is being addressed. In connection with these amendments, we also propose to revise the current disclosure requirements with respect to the retention of compensation consultants.[14]

II. DISCUSSION OF THE PROPOSALS

A. Proposed Listing Requirements

1. Applicability of Listing Requirements

In enacting Section 10C of the Exchange Act, Congress intended to require that "board committees that set compensation policy will consist only of directors who are independent."[15] In addition, Congress sought to provide "shareholders in a public company" with "additional disclosures involving compensation practices."[16] Although Section 10C includes numerous provisions applicable to the "compensation committees" of listed issuers, it does not require a

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[13] Section 10C(g) of the Exchange Act exempts controlled companies from the requirements of Section 10C.

[14] See Item 407(e) of Regulation S-K; Proxy Disclosure Enhancements, Release No. 33-9089 (Dec. 16, 2009) [74 FR 68334].

[15] See H.R. Rep. No. 111-517, Joint Explanatory Statement of the Committee of Conference, Title IX, Subtitle E "Accountability and Executive Compensation," at 872-873 (Conf. Rep.) (June 29, 2010).

[16] Id.

listed issuer to have a compensation committee or a committee that performs functions typically assigned to a compensation committee. Nor does Section 10C include provisions that have the effect of requiring a compensation committee as a practical matter. For example, it does not require that the compensation of executives be approved by a compensation committee.

Neither the Act nor the Exchange Act defines the term "compensation committee."[17] Our rules do not currently require, and our proposed rules would not mandate, that an issuer establish a compensation committee. However, current exchange listing standards generally require listed issuers either to have a compensation committee or to have independent directors determine, recommend or oversee specified executive compensation matters.[18] For example, the New York Stock Exchange ("NYSE") requires a listed issuer to have a compensation committee composed solely of independent directors and to assign various executive compensation-related tasks to that committee.[19] On the other hand, the NASDAQ Stock Market ("Nasdaq") does not mandate that a listed issuer have a compensation committee, but requires that executive compensation be determined or recommended to the board for determination either by a compensation committee

[17] By contrast, Section 3(a)(58) of the Exchange Act defines an "audit committee" as a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and if no such committee exists with respect to an issuer, the entire board of directors of the issuer. Our proposed rules would not preclude the exchanges from defining "compensation committee."

[18] There are some exchanges registered under Section 6(a) of the Exchange Act that have not adopted listing standards that require executive compensation determinations for listed issuers to be made or recommended by an independent compensation committee or independent directors. However, these exchanges, which include the International Securities Exchange, LLC, EDGA Exchange, Inc., EDGX Exchange, Inc., BATS Exchange, Inc., BATS Y-Exchange, Inc. and C2 Options Exchange, Inc., currently either trade securities only pursuant to unlisted trading privileges or trade only standardized options. In addition, the listing standards of certain exchanges that are registered with the Commission for the purpose of trading security futures do not address executive compensation matters. See Section II.B.1, below, for a discussion of these types of exchanges.

[19] See NYSE Listed Company Manual Section 303A.05. Section 303A.05 permits a listed issuer's board to allocate the responsibilities of the compensation committee to another committee, provided that the committee is composed entirely of independent directors and has a committee charter. The NYSE exempts certain issuers from this requirement, including controlled companies, limited partnerships, companies in bankruptcy, and closed-end and open-end management investment companies registered under the Investment Company Act of 1940 ("Investment Company Act"). See NYSE Listed Company Manual Section 303A.00.

composed solely of independent directors or by a majority of the board's independent directors in a vote in which only independent directors participate.[20] Some of the other exchanges have standards comparable to the NYSE's and require their listed issuers to have independent compensation committees.[21] Other exchanges have standards comparable to Nasdaq's and, in the absence of an independent compensation committee, permit executive compensation determinations to be made or recommended by a majority of independent directors on the listed issuer's board.[22]

Proposed Rule 10C-1(b) would direct the exchanges to adopt listing standards that would be applicable to any committee of the board that oversees executive compensation, whether or not the committee performs multiple functions and/or is formally designated as a "compensation committee." We believe this is appropriate in order to capture board committees that perform these functions and to avoid the possibility that a listed issuer might avoid the proposed requirements merely by assigning a different name to a committee that is functionally equivalent to a compensation committee. For example, if a listed issuer has a designated "corporate governance committee" whose responsibilities include, among other matters, oversight of executive compensation, such committee would be subject to the compensation committee listing standards to be adopted pursuant to our new rules, as would a committee designated as a "human

[20] See Nasdaq Rule 5605(d). We understand that less than 2% of Nasdaq listed issuers utilize the alternative of having independent board members, and not a committee, oversee compensation. See also Nasdaq IM 5605-6, stating that the Nasdaq structure is intended to provide flexibility for a company to choose an appropriate board structure and to reduce resource burdens, while ensuring independent director control of compensation decisions. Nasdaq exempts certain issuers from this requirement, including asset-backed issuers and other passive issuers, cooperatives, limited partnerships, and management investment companies registered under the Investment Company Act. See Nasdaq Rule 5615(a).

[21] NYSE Arca, Inc., National Stock Exchange, Inc., and NASDAQ OMX PHLX, Inc. See NYSE Arca Rule 5.3(k)(4); National Stock Exchange Rule 15.5(d)(5); and NASDAQ OMX PHLX Rule 867.05.

[22] NASDAQ OMX BX, Inc., NYSE Amex LLC, Chicago Board Options Exchange, Incorporated, and Chicago Stock Exchange, Inc. See NASDAQ OMX BX Rule 4350(c)(3); NYSE Amex Company Guide Section 805; Chicago Board Options Exchange Rule 31.10; and Chicago Stock Exchange Article 22, Rules 19(d) and 21.

resources committee" whose responsibilities include oversight of executive compensation. However, proposed Rule 10C-1(b) would not require the listing standards to apply to those independent directors who oversee executive compensation in lieu of a board committee, since Section 10C refers only to compensation committees.[23]

Request for Comment

- Should the exchanges be required to only list issuers with compensation committees?
- Our proposed rules would apply to a listed issuer's compensation committee, or in the absence of such a committee, any other board committee that performs functions typically performed by a compensation committee, including oversight of executive compensation. Is this proposed functional approach appropriate and workable? If not, why not?
- As noted above, the listing standards of some exchanges permit a listed issuer to have its executive compensation matters be determined, or recommended to the board for determination, either by a compensation committee composed solely of independent directors or, in the absence of such a committee, by a majority of independent directors in a vote in which only independent directors participate. Should our rules implementing Section 10C require the exchanges to mandate that independent directors performing this function in the absence of a formal committee structure also be subject to our new rules? Would so doing be consistent with the mandate of Section 10C of the Exchange Act?

[23] To the extent no board committee is authorized to oversee executive compensation, board determinations with respect to executive compensation matters may be made by the full board with only independent directors participating. In such cases, under state corporate law, we understand that action by the independent directors would generally be considered action by the full board, not action by a committee.

2. Independence Requirements

Most exchanges that list equity securities require that the board of directors of a listed issuer be composed of a majority of directors that qualify as "independent" under their listing standards.[24] As noted above, most exchanges that list equity securities require directors on compensation committees or directors determining or recommending executive compensation matters to be "independent" under their general independence standards. Although independence requirements and standards for determining independence vary somewhat among the different exchanges, listing standards prescribe certain bright-line independence tests (including restrictions on compensation, employment and familial or other relationships with the listed issuer that could interfere with the exercise of independent judgment) that directors must meet in order to be considered independent. For example, both NYSE and Nasdaq rules preclude a finding of independence if the director is or recently was employed by the listed issuer,[25] the director's immediate family member is or recently was employed as an executive officer of the listed issuer,[26] or the director or director's family member received compensation from the listed issuer in excess of specified limits.[27] In addition, under both NYSE and Nasdaq rules, directors may be disqualified based on their or their family members' relationships with a listed issuer's auditor,[28] affiliation with entities that have material business relationships with the

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[24] See NYSE Listed Company Manual Section 303A.01; Nasdaq Rule 5605(b)(1); NYSE AMEX LLC Company Guide Section 802(a); Chicago Board Options Exchange Rule 31.10(a); Chicago Stock Exchange Article 22, Rules 19(a) and 21(a); NASDAQ OMX BX Rule 4350(c)(1); NASDAQ OMX PHLX Rule 867.01; National Stock Exchange Rule 15.5(d)(1). NYSE Amex and the Chicago Stock Exchange permit smaller issuers to have a 50% independent board. See NYSE Amex Company Guide Section 801(h); Chicago Stock Exchange Article 22, Rules 19(a), 19(b)(1)(C)(iii), and 21(a).

[25] See NYSE Listed Company Manual Section 303A.02(b)(i); Nasdaq Rule 5605(a)(2)(A).

[26] See NYSE Listed Company Manual Section 303A.02(b)(i); Nasdaq Rule 5605(a)(2)(C).

[27] See NYSE Listed Company Manual Section 303A.02(b)(ii); Nasdaq Rule 5605(a)(2)(B).

[28] See NYSE Listed Company Manual Section 303A.02(b)(iii); Nasdaq Rule 5605(a)(2)(F).

listed issuer,[29] or employment at a company whose compensation committee includes any of the listed issuer's executive officers.[30] We note, however, that with the exception of audit committee membership requirements, stock ownership alone will not automatically preclude a director from being considered independent under either NYSE or Nasdaq listing standards.[31]

In addition to requiring directors to meet objective criteria of independence, the NYSE and Nasdaq also require their listed issuers' boards to affirmatively determine that each independent director either, in NYSE's case, has no material relationship with the company[32] or, in Nasdaq's case, has no relationship which, in the opinion of the issuer's board of directors, would interfere with the director's exercise of independent judgment in carrying out his or her responsibilities.[33] The other exchanges have similar requirements.[34]

Under current Commission rules, listed issuers are required to identify each director who is independent, using the same definition of independence used for determining whether a majority of the board of directors is independent.[35] If an exchange has independence requirements for members of the compensation committee, then listed issuers are required to identify each member of the compensation committee who is not independent under those requirements.[36] If a listed issuer does not have a separately designated compensation committee

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[29] See NYSE Listed Company Manual Section 303A.02(b)(v); Nasdaq Rule 5605(a)(2)(D).

[30] See NYSE Listed Company Manual Section 303A.02(b)(iv); Nasdaq Rule 5605(a)(2)(E).

[31] See Commentary to NYSE Listed Company Manual Section 303A.02(a); Nasdaq Rule 5605; Nasdaq IM-5605.

[32] See NYSE Rule 303A.02.a

[33] See Nasdaq Rule 4200(a)(15).

[34] See, e.g., NYSE Arca Rule 5.3(k)(1) or NYSE AMEX LLC Company Guide Section 803.A.02.

[35] Item 407(a) of Regulation S-K.

[36] Id.

or committee performing similar functions, then the issuer must identify all members of the board who do not meet the independence requirements for compensation committee members.[37]

In addition to meeting exchange listing standards, there are other reasons for members of the compensation committee to be independent. For example, in order for a securities transaction between an issuer and one of its officers or directors to be exempt from short-swing profit liability under Section 16(b) of the Exchange Act, the transaction must be approved by the full board of directors or by a committee of the board that is composed solely of two or more "Non-Employee Directors," as defined in Exchange Act Rule 16b-3(b)(3).[38] We understand that many issuers use their independent compensation committees to avail themselves of this exemption.[39] Similarly, if an issuer wishes to preserve the tax deductibility of the amounts of certain awards paid to executive officers, among other things, the performance goals of such awards must be determined by a compensation committee composed of two or more "outside directors," as defined in Section 162(m) of the Internal Revenue Code.[40] The definitions of

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[37] Id.

[38] As defined in Exchange Act Rule 16b-3(b)(3)(i) [17 CFR 240.16b-3(b)(3)(i)], a "Non-Employee Director" is a director who is not currently an officer (as defined in Rule 16a-1(f)) of the issuer or a parent or subsidiary of the issuer, or otherwise currently employed by the issuer or a parent or subsidiary of the issuer; does not receive compensation, either directly or indirectly, from the issuer or a parent or subsidiary of the issuer, for services rendered as a consultant or in any capacity other than as a director, except for an amount that does not exceed the dollar amount for which disclosure would be required pursuant to Item 404(a) of Regulation S-K; and does not possess an interest in any other transaction for which disclosure would be required pursuant to Item 404(a) of Regulation S-K. In addition, Rule 16b-3(b)(3)(ii) provides that a Non-Employee Director of a closed-end investment company is a director who is not an "interested person" of the issuer, as that term is defined in Section 2(a)(19) of the Investment Company Act [15 U.S.C. 80a-2(a)(19)].

[39] See letter from Sullivan and Cromwell LLP to Facilitating Shareholder Director Nominations, Release No. 34-60089, available at http://www.sec.gov/comments/s7-10-09/s71009-430.pdf ("In our experience, many compensation committee charters require their members to meet the requirements of Rule 16b-3 and Section 162(m)."); Ira G. Bogner & Michael Krasnovsky, *Exchange Rules Impact Compensation Committee Composition*, METROPOLITAN CORP. COUNS., April 2004, at 17 ("Most compensation committees of public companies include at least two directors that are 'outside directors' under Section 162(m) of the Internal Revenue Code . . . and 'non-employee directors' under Rule 16b-3 of the Securities Exchange Act . . . .").

[40] A director is an "outside director" if the director (A) is not a current employee of the publicly held corporation; (B) is not a former employee of the publicly held corporation who receives compensation for prior services (other than benefits under a tax-qualified retirement plan) during the taxable year; (C) has not been an officer of the

"Non-Employee Director" and "outside director" are similar to the exchanges' definitions of director independence.

In order to implement the requirements of Section 10C(a)(1) of the Exchange Act, proposed Rule 10C-1(b)(1)(i) would require each member of a listed issuer's compensation committee to be a member of the issuer's board of directors and to be independent. As required by Section 10C(a)(1), proposed Rule 10C-1(b)(1)(ii) would direct the exchanges to develop a definition of independence applicable to compensation committee members after considering relevant factors, including, but not limited to, the source of compensation of a director, including any consulting, advisory or other compensatory fee paid by the issuer to such director, and whether the director is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer. Other than the factors set out in Section 10C(a)(1), we do not propose to specify any additional factors that the exchanges must consider in determining independence requirements for members of compensation committees, although we request comment regarding whether there are any other such factors that should be included in our rule.

In proposing Rule 10C-1(b)(1), we considered the similarities and differences between Section 952 of the Act and Section 301 of the Sarbanes-Oxley Act of 2002.[41] Section 301 of the Sarbanes-Oxley Act added Section 10A(m)(1) to the Exchange Act,[42] which required the Commission to direct the exchanges to prescribe independence requirements for audit committee members. Although the independence factors in Section 10C(a)(1) are similar to those in Section 10A(m)(1) – and indeed, Section 952 of the Act essentially provides the compensation

publicly held corporation; and (D) does not receive remuneration from the publicly held corporation, either directly or indirectly, in any capacity other than as a director. For this purpose, remuneration includes any payment in exchange for goods or services. Section 162(m) of the Internal Revenue Code of 1986, as amended. Treas. Reg. Section 1.162-27(e)(3).

[41] Pub. L. 107-204, 116 Stat. 745 (2002).

[42] 15 U.S.C. 78j-1(m)(1).

committee counterpart to the audit committee requirements of Section 301 of the Sarbanes-Oxley Act – there is one significant difference. Section 10C(a) requires only that the exchanges "consider relevant factors" (emphasis added), which include the source of compensation and any affiliate relationship, in developing independence standards for compensation committee members, whereas Section 10A(m) expressly states that certain relationships preclude independence: an audit committee member "may not, other than in his or her capacity as a member of the audit committee…[a]ccept any consulting, advisory, or other compensatory fee from the issuer; or [b]e an affiliated person of the issuer or any subsidiary thereof" (emphasis added).[43]

As a result, the exchanges have more discretion to determine the standards of independence that audit committee and compensation committee members are required to meet. Section 10A(m) prescribes minimum criteria for the independence of audit committee members and permits the exchanges to adopt more stringent independence criteria as they deem appropriate, subject to approval pursuant to Section 19(b) of the Exchange Act. In contrast, Section 10C gives the exchanges the flexibility to establish their own minimum independence criteria for compensation committee members after considering the relevant factors enumerated in Section 10C(a)(3)(A)-(B). The exchanges may add other factors, as each such exchange deems appropriate, subject to approval pursuant to Section 19(b) of the Exchange Act.

To comply with proposed Rule 10C-1, the exchanges' definitions of independence for compensation committee members would be implemented through proposed rule changes that

[43] See Section 10A(m) of the Exchange Act. Exchange Act Rule 10A-3 states that in order to be considered "independent," an audit committee member cannot accept any consulting, advisory or other compensatory fee (other than receipt of fixed amounts under a retirement plan for prior service with the listed issuer) and, for non-investment company issuers, cannot be an affiliated person of the issuer or its subsidiaries. For investment company issuers, the audit committee member cannot be an "interested person" of the issuer as defined in Section 2(a)(19) of the Investment Company Act.

the exchanges would file pursuant to Section 19(b) of the Exchange Act, which are subject to the Commission's approval.[44] Proposed Rule 10C-1(a)(4) would require that each proposed rule change submission include, in addition to any information required under Section 19(b) of the Exchange Act and the rules thereunder: a review of whether and how existing or proposed listing standards satisfy the requirements of this rule; a discussion of the exchange's consideration of factors relevant to compensation committee member independence; and the definition of independence applicable to compensation committee members that the exchange proposes to adopt in light of such review.[45] The Commission would then consider, prior to final approval, whether the exchanges considered the relevant factors outlined in Section 10C(a) and whether the exchanges' proposed rule changes are consistent with the requirements of Section 6(b) of the Exchange Act.

Because these relevant factors cover the same matters as the prohibitions in Section 10A(m)'s definition of audit committee independence, we believe the exchanges would likely consider whether those prohibitions should also be applicable to compensation committee members. The exchanges would not be required to adopt those prohibitions in their definitions and will have flexibility to consider other factors in developing their definitions. For example, we understand that there are concerns, as expressed by several commentators,[46] about a

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[44] The standard of review for approving proposed exchange listing standards is found in Section 19(b)(2)(C) of the Exchange Act, which provides that "[t]he Commission shall approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of this title and the rules and regulations issued under this title that are applicable to such organization." Under Section 6(b) of the Exchange Act, the rules of an exchange must be "designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest."

[45] A filing would be required even if an exchange finds that its existing rules satisfy the requirements of proposed Rule 10C-1.

[46] To facilitate public input on the Act, the Commission has provided a series of e-mail links, organized by topic, on its website at http://www.sec.gov/spotlight/regreformcomments.shtml. The public comments we received are

prohibition against allowing directors affiliated with significant investors (such as private equity funds or venture capital firms) to serve on compensation committees.[47] Some commentators have noted that such directors are highly motivated to rigorously oversee compensation and are well-positioned to exercise independent judgment regarding compensation.[48] In addition, some commentators have noted that, although there is a need for audit committee members to be able to exercise objective oversight of an issuer's financial reporting, with respect to the oversight of executive compensation, the interests of representatives of major shareholders are generally aligned with those of other shareholders.[49]

The exchanges may determine that, even though affiliated directors are not allowed to serve on audit committees, such a blanket prohibition would be inappropriate for compensation committees, and certain affiliates, such as representatives of significant shareholders, should be permitted to serve. The exchanges might also conclude that other relationships or factors linked more closely to executive compensation matters, such as relationships between the members of the compensation committee and the listed issuer's executive management, should be addressed in the definition of independence.

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available on our website at http://www.sec.gov/comments/df-title-xv/specialized-disclosures/specializeddisclosures-8.pdf. The public comments we have received on Section 952 of the Act are available on our website at http://www.sec.gov/comments/df-title-ix/executive-compensation/executive-compensation.shtml.

Several commentators have suggested that stock ownership alone should not automatically disqualify a board member from serving as an independent director on the compensation committee. See, e.g., letters from American Bar Association, Brian Foley & Company, Inc, Compensia, Davis Polk & Wardwell, LLP and Frederick W. Cook & Co., Inc.

[47] One of these commentators noted that one or more venture capital firms sometimes hold significant equity positions and also have one of their partners serving as a director and member of the board's compensation committee. In this commentator's experience, these individuals, by virtue of their ongoing history with the listed company as well as their familiarity and experience with executive compensation practices in their industry sector, are valuable members of the compensation committee who can offer perspective and expertise which are largely in line with that of that of the company's shareholders. See letter from Compensia.

[48] See letter from Frederic W. Cook & Co., Inc. (stating that venture capital and private equity firms "will often have a more demanding pay-for-performance orientation than any other category of investor").

[49] See, e.g., letters from Davis Polk & Wardwell LLP, American Bar Association, Compensia and Frederic W. Cook & Co., Inc.

Because the compensation committee independence requirements of Section 10C, unlike the audit committee independence requirements of Section 10A(m), do not require that the exchanges prohibit all affiliates from serving on a compensation committee, we do not believe it is necessary to separately define the term "affiliate" for purposes of proposed Rule 10C-1. As our proposed rule does not establish required independence standards, we also believe it is unnecessary to create any safe harbors for particular relationships, as we did when we adopted our audit committee independence requirements.[50] Although each exchange must consider the affiliate relationships specified in the rule in establishing compensation committee independence standards, there is no requirement to adopt listing standards precluding compensation committee membership based on all such relationships. Accordingly, we do not propose a separate definition of "affiliate" for use in connection with proposed Rule 10C-1.

Request for Comment

- Rather than establishing minimum independence standards that the exchanges must apply to compensation committee members, our proposed rule would permit each exchange to establish its own independence criteria, provided the exchange considers the relevant factors specified in Section 10C relating to affiliate relationships and sources of compensation. Is this approach appropriate? Is there a better approach that would be consistent with the requirements of Section 10C?
- The proposed independence factors that must be considered relate to current relationships between the issuer and the compensation committee member, which is consistent with the approach in Rule 10A-3(b)(1) for audit committee members.

[50] See Exchange Act Rule 10A-3(e)(1)(ii) [17 CFR 240.10A-3(e)(1)(ii)] (providing that a person will be deemed not to be in control of a specified person for purposes of this section if the person "is not the beneficial owner, directly or indirectly, of more than 10% of any class of voting equity securities of the specified person; and is not an executive officer of the specified person").

Should the required factors also extend to a "look back" period before the appointment of the member to the compensation committee? (We note that the exchanges currently have look-back periods for their definitions of independence for purposes of determining whether a majority of the board of directors is independent.) For members already serving on compensation committees when the new listing standards take effect, should the required factors also extend to a "look back" period before the effective date of the new listing standards? If so, what period (e.g., three years or five years) would be appropriate? Should there be different look-back periods for different relationships or different parties? If so, what should they be, and why?

- Should there be additional factors apart from the two proposed factors required to be considered? For example, should the exchanges be required to include business or personal relationships between a compensation committee member and an executive officer of the issuer as mandatory factors for consideration? Should the exchanges be required to include board interlocks or employment of a director at a company included in the listed issuer's compensation peer group as mandatory factors for consideration? Would any such requirements unduly restrain a company in setting the composition of its board of directors?
- Large shareholders may be deemed affiliates by virtue of the percentage of their shareholdings. As noted above, some commentators have expressed the view that directors affiliated with large shareholders should continue to be permitted to serve on compensation committees because their interests are aligned with other shareholders with respect to compensation matters. Would a director affiliated with a shareholder

with a significant ownership interest who is otherwise independent be sufficiently independent for the purpose of serving on the compensation committee? Would the interests of all shareholders be aligned with the interests of large shareholders with respect to oversight of executive compensation? Should our rules implementing Section 10C provide additional or different guidance or standards for the consideration of the affiliated person factor?

3. Authority to Engage Compensation Advisers; Responsibilities; and Funding

Section 10C(c)(1) of the Exchange Act provides that the compensation committee of a listed issuer may, in its sole discretion, retain or obtain the advice of a "compensation consultant,"[51] and Section 10C(d)(1) extends this authority to "independent legal counsel and other advisers"[52] (collectively, "compensation advisers"). Both sections also provide that the compensation committee shall be directly responsible for the appointment, compensation, and oversight of the work of compensation advisers. Sections 10C(c)(1)(C) and 10C(d)(3) provide that the compensation committee's authority to retain, and responsibility for overseeing the work of, compensation advisers may not be construed to require the compensation committee to implement or act consistently with the advice or recommendations of a compensation adviser or to affect the ability or obligation of the compensation committee to exercise its own judgment in fulfillment of its duties. To ensure that the listed issuer's compensation committee has the necessary funds to pay for such advisers, Section 10C(e) provides that a listed issuer shall provide "appropriate funding," as determined by the compensation committee, for payment of

[51] See Exchange Act Section 10C(c)(1).

[52] See Exchange Act Section 10C(d)(1).

"reasonable compensation" to compensation consultants, independent legal counsel and other advisers to the compensation committee.[53]

Proposed Rule 10C-1(b)(2) implements Sections 10C(c)(1) and (d)(1) by repeating the provisions set forth in those sections regarding the compensation committee's authority to retain or obtain a compensation adviser, its direct responsibility for the appointment, compensation and oversight of the work of any compensation adviser, and the related rules of construction. In addition, proposed Rule 10C-1(b)(3) implements Section 10C(e) by repeating the provisions set forth in that section regarding the requirement that listed issuers provide for appropriate funding for payment of reasonable compensation to compensation advisers.

We note that while the statute provides that compensation committees of listed issuers shall have the express authority to hire "independent legal counsel," the statute does not require that they do so. Similar to our interpretation[54] of Section 10A(m) of the Exchange Act, which gave the audit committee authority to engage "independent legal counsel,"[55] we do not construe the requirements related to independent legal counsel and other advisers as set forth in Section 10C(d)(1) of the Exchange Act as requiring a compensation committee to retain independent legal counsel or as precluding a compensation committee from retaining non-independent legal counsel or obtaining advice from in-house counsel or outside counsel retained by the issuer or management.

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[53] See Exchange Act Section 10C(e).

[54] See Standards Relating to Listed Company Audit Committees, Release No. 33-8220 (Apr. 9, 2003) [68 FR 18788], at fn. 114 ("As proposed, the requirement does not preclude access to or advice from the company's internal counsel or regular outside counsel. It also does not require an audit committee to retain independent counsel.").

[55] See Exchange Act Section 10A(m)(5)("Each audit committee shall have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties.").

Request for Comment

- Is additional specificity in the proposed rule needed to provide clearer guidance to listed issuers? For example, should we define what constitutes an "independent legal counsel"? If so, how?
- Should we clarify more explicitly in the implementing rule that this provision is not intended to preclude the compensation committee from conferring with in-house legal counsel or the company's outside counsel or from retaining non-independent counsel?
- Our audit committee rules implementing Section 10A(m) provide that each listed issuer must provide funding for ordinary administrative expenses of the audit committee that are necessary or appropriate in carrying out its duties.[56] Would such a provision be helpful with respect to the compensation committee? Do compensation committees have administrative expenses? If so, are they significant?

4. Compensation Adviser Independence Factors

Section 10C(b) of the Exchange Act provides that the compensation committee may select a compensation adviser only after taking into consideration the factors identified by the Commission. In accordance with Section 10C(b), these factors would apply not only to the selection of compensation consultants, but also to the selection of legal counsel and other advisers to the committee. The statute does not require a compensation adviser to be independent, only that the compensation committee consider the enumerated independence factors before selecting a compensation adviser. Section 10C(b) specifies that the independence factors identified by the Commission must be competitively neutral[57] and include, at minimum:

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[56] See Exchange Act Rule 10A-3(b)(5)(iii).

[57] Although there is no relevant legislative history, we assume this is intended to address the concern expressed by the multi-service compensation consulting firms that the disclosure requirements the Commission adopted last year are not competitively neutral because they do not address potential conflicts of interest presented by boutique

- The provision of other services to the issuer by the person that employs the compensation consultant, legal counsel or other adviser;
- The amount of fees received from the issuer by the person that employs the compensation consultant, legal counsel or other adviser, as a percentage of the total revenue of the person that employs the compensation consultant, legal counsel, or other adviser;
- The policies and procedures of the person that employs the compensation consultant, legal counsel or other adviser that are designed to prevent conflicts of interest;
- Any business or personal relationship of the compensation consultant, legal counsel, or other adviser with a member of the compensation committee; and
- Any stock of the issuer owned by the compensation consultant, legal counsel or other adviser.

Because Exchange Act Section 10C does not require compensation advisers to be independent – only that the compensation committee consider factors that may bear upon independence – we do not believe that this provision contemplates that the Commission would necessarily establish materiality or bright-line numerical thresholds that would determine whether or when the factors listed in Section 10C of the Exchange Act, or any other factors added by the Commission or by the exchanges, must be considered germane by a compensation committee. For example, we do not believe that our rules should provide that a committee must consider stock owned by an adviser only if ownership exceeds a specified minimum percentage of the issuer's stock, or that a committee must consider the amount of revenues that the issuer's

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consulting firms that are dependent on the revenues of a small number of clients. See letter from Towers Perrin, commenting on Proxy Disclosure and Solicitation Enhancements, Release No. 33-9052 (July 10, 2009), available at http://www.sec.gov/comments/s7-13-09/s71309-90.pdf. The list in Section 10C, which covers both multi-service firm "other services" conflicts and boutique firm "revenue concentration" conflicts, is consistent with this assumption.

business represents for an adviser only if the percentage exceeds a certain percentage of the adviser's revenues. Therefore, proposed Rule 10C-1(b)(4) would require the listing standards developed by the exchanges to include the independence factors set forth in the statute and incorporated into the rule without any materiality or bright-line thresholds or cut-offs. Under the proposed rules, the exchanges may add other independence factors that must be considered by compensation committees of listed issuers.

We believe the factors set forth in Section 10C(b) are generally comprehensive. We are not proposing any additional compensation adviser independence factors at this time, although we are soliciting comment as to whether there are any additional independence factors that should be taken into consideration by a listed issuer's compensation committee when selecting a compensation adviser. We are also soliciting comment as to whether the factors set forth in Section 10C(b) and proposed Rule 10C-1(b)(4) are competitively neutral.

We have already received several comment letters with respect to the compensation adviser independence factors.[58] Commentators are generally supportive of the five factors listed in Section 10C(b), but believe that the factors should be used only in guiding the compensation committee in its selection process, not as an outright bar or prohibition against any one category of compensation adviser.[59] One commentator stated that in requiring the factors to be "competitively neutral," Congress sought to ensure that companies "have the flexibility to select the types of adviser[s] that best meet their particular needs."[60] Several commentators suggested that the stock ownership independence factor should relate only to shares of the listed issuer owned directly by the consulting firm or by advisers immediately engaged by the compensation

[58] See, e.g., letters from Mercer, Meridian Compensation Partners, LLC, Pay Governance LLC and Frederick W. Cook & Co., Inc.

[59] See, e.g., letter from Pay Governance LLC.

[60] See letter from Towers Watson.

committee.[61] Other commentators sought clarification on what constitutes a "business" or "personal" relationship between the compensation adviser and a member of the compensation committee.[62] In light of our overall approach to implementing the independence factors as provided in Section 10C(b), we are not proposing to address these points, but solicit comment below on whether we should.

Request for Comment

- Section 10C(b) specifies that the independence factors identified by the Commission must be competitively neutral, but does not state how we should determine whether a factor is competitively neutral. Are there any issues that should be considered to determine or assess whether a factor is competitively neutral?
- Are the five factors identified in Section 10C(b) of the Exchange Act competitively neutral among different types of compensation advisers? If not, what modifications or adjustments should be made in order to make these factors competitively neutral? Are there specific categories of compensation advisers that would be adversely affected by the compensation committee's use of these factors to assess independence?
- Are there any factors affecting independence that we should add to the list of factors identified in proposed Rule 10C-1(b)(4)? If so, what are they and why should they be included?
- Would the existence of a business or personal relationship between a compensation adviser and an executive officer of the issuer be relevant in considering whether to

[61] See, e.g., letters from Frederick W. Cook & Co., Inc and Mercer.

[62] See, e.g., letters from Mercer and Pay Governance LLC.

engage the compensation adviser? If so, why? Should we add this to the required list of factors that must be considered?

- Based on the language in Section 10C(b)(2), which distinguishes between the adviser and the person that employs the adviser, a personal or business relationship between the person employing the adviser and a member of the compensation committee would not be covered by the proposed rule (which, like Section 10C(b)(2)(D), only refers to relationships between the adviser and the compensation committee). Should the required list of factors also include a business or personal relationship between the person employing the compensation adviser and a member of the compensation committee? Along those lines, should it also cover a business or personal relationship between the person employing the adviser and an executive officer of the issuer?
- Should we provide materiality, numerical or other thresholds that would apply to whether or when the independence factors must be considered by a compensation committee? If so, what should they be? For example, should we require consideration of stock ownership only if the amount of stock owned constitutes a significant portion of an adviser's net worth, such as 10%?
- Would law firms be affected by the requirement to consider independence factors in a way that would be materially different than how compensation consultants would be affected?
- Should we clarify what is covered by "provision of other services" in proposed Rule 10C-1(b)(4)(i)?
- We interpret "any stock of the issuer owned by the compensation consultant, independent legal counsel or other adviser" in proposed Rule 10C-1(b)(4)(v) to

include shares owned by the individuals providing services to the compensation committee and their immediate family members. We do not believe this factor is intended to extend to the person that employs the adviser since Section 10C(b) is specific when factors extend to the employer and that language is not included for stock ownership. Is this an appropriate interpretation of this factor? If not, why and how should this phrase be interpreted? Should it also cover the person that employs the adviser?

- Should we define or clarify the meaning of the phrase "business or personal relationship," as used in proposed Rule 10C-1(b)(4)(iv), and if so, how?
- Would the proposed requirements have any unintended effects on the compensation committee or its process to select a compensation adviser? If so, please explain.
- Should we adopt rule amendments to Regulation S-K to require listed issuers to describe the compensation committee's process for selecting compensation advisers pursuant to the new listing standards? Would information about the compensation committee's selection process – how it works, what it requires, who is involved, when it takes place, whether it is followed – provide transparency to the compensation adviser selection process and provide investors with information that may be useful to them as they consider the effectiveness of the selection process? Or, would such a requirement result in too much detail about this process in the context of disclosure regarding executive compensation?

5. Opportunity to Cure Defects

Section 10C(f)(2) of the Exchange Act specifies that our rules must provide for appropriate procedures for an issuer to have a reasonable opportunity to cure any defects that would be the basis for a prohibition of the listing of an issuer's securities as a result of its failure to meet the requirements set forth in Section 10C, before imposition of such a prohibition.[63] To implement this requirement, proposed Rule 10C-1(a)(3) would require the exchanges to establish such procedures (if their existing procedures are not adequate) before they prohibit the listing of, or delist, any security of an issuer.

As a preliminary matter, we believe that existing continued listing or maintenance standards and delisting procedures of most of the exchanges would satisfy the requirement for there to be reasonable procedures for an issuer to have an opportunity to cure any defects on an ongoing basis. Most exchanges have already adopted procedures to provide issuers with notice and opportunity for a hearing, an opportunity for an appeal and an opportunity to cure defects before their securities are delisted.[64] Nonetheless, we expect that the rules of each exchange would provide for definite procedures and time periods for compliance with the proposed requirements to the extent they do not already do so.

When we adopted Exchange Act Rule 10A-3(a)(3), which requires that issuers be given an opportunity to cure violations of the audit committee listing requirements, we noted that several commentators to the proposing release for those rules expressed concern regarding rare situations that may occur where an audit committee member ceases to be independent for reasons outside the member's reasonable control.[65] For example, a listed issuer's audit committee

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[63] See Exchange Act Section 10C(f)(2).

[64] See, e.g., NYSE Listed Company Manual Section 801-805; Nasdaq Equity Rules 5800 Series; NYSE AMEX LLC Company Guide Section 1009 and Part 12; Chicago Board Options Exchange Rule 31.94; Chicago Stock Exchange Article 22, Rules 4, 17A, and 22; Nasdaq OMX BX Rule 4800 series; Nasdaq OMX PHLX Rule 811. Neither NYSE Arca nor the National Stock Exchange has a rule that specifically requires listed companies to be given an opportunity to submit a plan to regain compliance with corporate governance listing standards other than audit committee requirements; issuers listed on these exchanges, however, are provided notice, an opportunity for a hearing, and an opportunity for an appeal prior to delisting. See NYSE Arca Rule 5.5(m); National Stock Exchange Rule 15.7 and Chapter X.

[65] See Standards Relating to Listed Company Audit Committees, Release No. 33-8220 (Apr. 9, 2003).

member could be a partner in a law firm that provides no services to the listed issuer, but the listed issuer could acquire another company that is one of the law firm's clients. Without an opportunity to cure such a defect, the audit committee member would cease to be independent. Additional time may be necessary to cure such defects, such as ceasing the issuer's relationship with the audit committee member's firm or replacing the audit committee member. Accordingly, in our final rule, we provided that the exchanges' rules may provide that if a member of an audit committee ceases to be independent for reasons outside the member's reasonable control, that person, with notice by the issuer to the applicable national securities exchange or national securities association, may remain an audit committee member of the listed issuer until the earlier of the next annual meeting of the listed issuer or one year from the occurrence of the event that caused the member to be no longer independent.[66]

We are proposing that there should be the same opportunity to cure violations of the independence requirements for compensation committee members, for the same reasons we adopted such provisions for curing violations of the independence requirements for audit committee members. Accordingly, consistent with Rule 10A-3(a)(3), proposed Rule 10C-1(a)(3) provides that the exchanges' rules may provide that if a member of a compensation committee ceases to be independent for reasons outside the member's reasonable control, that person, with notice by the issuer to the applicable exchange, may remain a compensation committee member of the listed issuer until the earlier of the next annual meeting of the listed issuer or one year from the occurrence of the event that caused the member to be no longer independent.

[66] See Exchange Act Rule 10A-3(a)(3) [17 CFR 240.10A-3(a)(3)].

Request for Comment

- Should the exchanges be required to establish specific procedures for curing defects regarding compliance with compensation committee listing requirements apart from those proposed? If so, what should these procedures be? Should there be a specific course for redress other than the delisting process?
- Should our rule, as proposed, allow exchange rules that would permit the continued service of a compensation committee member who ceases to be independent for reasons outside the member's reasonable control? If so, should our rule impose a maximum time limit for such continued service? Should our rule require that the issuer use reasonable efforts to replace the member who is no longer independent as promptly as practicable?
- Should our rule include specific provisions that set time limits for an opportunity to cure defects other than for instances where a compensation committee member ceases to be independent for reasons outside the member's reasonable control? If so, what time limits would be appropriate?
- Should companies that have just completed initial public offerings be given additional time to comply with the requirements, as is permitted by Exchange Act Rule 10A-3(b)(1)(iv)(A) with respect to audit committee independence requirements?

B. Implementation of Listing Requirements

1. Exchanges Affected

Section 10C of the Exchange Act by its terms applies to all national securities exchanges and national securities associations.[67] These entities, to the extent that their listing standards do

[67] The OTC Bulletin Board (OTCBB) and the OTC Markets Group (previously known as the Pink Sheets and Pink OTC Markets) would not be affected by the proposed requirements, and therefore issuers whose securities are

not already comply with the rules we adopt under Section 10C, will be required to issue or modify their rules, subject to Commission review, to conform their listing standards to our new rules. An exchange that lists or trades security futures products (as defined in Exchange Act Section 3(a)(56))[68] may register as a national securities exchange under Section 6(g) of the Exchange Act solely for the purpose of trading security futures products.[69] Because the Exchange Act definition of "equity security" includes security futures on equity securities,[70] we believe it is necessary to clarify the application of proposed Rule 10C-1 to those national securities exchanges registered solely pursuant to Section 6(g).

Given that Section 10C(f) of the Act makes no distinction between exchanges registered pursuant to Section 6(a) and those registered pursuant to Section 6(g), we have not proposed a wholesale exemption from the requirements of Rule 10C-1 for those exchanges registered solely pursuant to Section 6(g). However, as discussed below, we are proposing to exempt security futures products from the scope of proposed Rule 10C-1. Accordingly, to the extent our final rule exempts the listing of security futures products from the scope of Rule 10C-1, any national

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quoted on these interdealer quotation systems similarly would not be affected, unless their securities also are listed on an exchange. The OTCBB is an interdealer quotation system for the over-the-counter securities market operated by FINRA that collects and distributes market maker quotes to subscribers. It does not, however, have a listing agreement or arrangement with the issuers whose securities are quoted on the system. Although market makers may be required to review and maintain specified information about the issuer and to furnish that information to the OTCBB, the issuers whose securities are quoted on it are not required to file any information with the system. The OTC Markets Group is not a registered national securities exchange or association, nor is it operated by a registered national securities exchange or association, and thus is not covered by the terms of the proposed rule.

68 Exchange Act Section 3(a)(56) defines the term ''security futures product'' to mean "a security future or any put, call, straddle, option, or privilege on any security future." 15 U.S.C. 78c(a)(56).

69 Exchanges currently registered solely pursuant to Section 6(g) of the Exchange Act include the Board of Trade of the City of Chicago, Inc.; the CBOE Futures Exchange, LLC; the Chicago Mercantile Exchange, Inc.; One Chicago, LLC; the Island Futures Exchange, LLC; and NQLX LLC.

70 Under Section 3(a)(11) of the Exchange Act, the term "equity security" is defined as any stock or similar security; or any security future on any such security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security.

securities exchange registered as such solely pursuant to Section 6(g) of the Exchange Act and that lists and trades only security futures products would not be required to file a rule change in order to comply with Rule 10C-1.

Currently, the only registered national securities association under Section 15A(a) of the Exchange Act is FINRA.[71] However, FINRA does not list securities.[72] While we recognize that Section 10C of the Act specifically requires national securities associations to prohibit the listing of any equity security of an issuer that does not comply with the requirements of Section 10C, as FINRA does not list any securities and does not have listing standards under its rules, we do not expect FINRA to have to develop listing standards regarding compensation committees in compliance with proposed Rule 10C-1.[73] Nevertheless, as Section 10C specifically references national securities associations, proposed Rule 10C-1 would apply to any registered national securities association that lists equity securities in the future.

Request for Comment

- Should we exempt certain exchanges or associations from Section 10C of the Exchange Act? If so, why, and which exchanges or associations should we exempt and why?
- Would we need to exempt an exchange from Section 10C if we also exempt the class of securities listed on such exchange?

[71] Regarding the National Futures Association (NFA), see note 6, above, and note 73, below.

[72] See note 6, above.

[73] Similarly, we do not expect the NFA, which is registered under Section 15A(k) for the limited purpose of regulating the activities of members who are registered as broker-dealers in security futures products, see note 6, above, to develop listing standards regarding compensation committees in compliance with proposed Rule 10C-1.

2. Securities Affected

a. Listed Equity Securities

Section 10C of the Exchange Act specifies in one subsection that the compensation committee listing requirements are intended to apply to issuers with listed equity securities, but another subsection may suggest that it applies to issuers with any listed securities. Section 10C(a) provides that the Commission shall direct the exchanges to prohibit the listing of any "equity security" of an issuer (other than several types of exempted issuers) that does not comply with the compensation committee member independence requirements. Section 10C(f)(1), which states generally the scope of the compensation committee and compensation adviser listing requirements, provides that, "[n]ot later than 360 days after the date of enactment of this section, the Commission shall, by rule, direct the national securities exchanges and national securities associations to prohibit the listing of <u>any security</u> of an issuer that is not in compliance with the requirements of this section" (emphasis added).

The Senate-passed version of the bill did not distinguish between equity and non-equity securities, referencing only the prohibition against the listing of "any security" of an issuer not in compliance with the independence requirements. The House-passed version would have required the Commission to adopt rules to direct the exchanges to prohibit the listing of "any class of equity security" of an issuer that is not in compliance with the compensation committee independence standards, as well as with any of the other provisions of that section, including the provisions relating to compensation advisers. According to a press release from the House Financial Services Committee, this language was added during final House deliberations to clarify that the compensation committee independence standards would apply only to "public companies, not to companies that have only an issue of publicly-registered debt."[74]

Because the Senate-passed version of the bill (which did not specify "equity" securities) was used as the base for the conference draft, it appears that addition of "equity" securities in Section 10C(a) of the conference draft is deliberate. Unlike the House-passed bill, however, the final bill specifically references equity securities only in connection with compensation committee independence requirements.

Based on this legislative history, we believe that the compensation committee and other requirements in Section 10C are intended to apply only to issuers with listed equity securities.[75] As noted above, the provision governing compensation committee independence is specifically limited to issuers of equity securities. Against this backdrop, in our view, it is unlikely that Congress intended the remaining compensation committee provisions (compensation adviser independence factors, authority to retain compensation advisers, and responsibility for the appointment, compensation and oversight of the work of the compensation advisers) to apply to issuers with only listed debt securities. We note that the NYSE currently exempts debt-only listed issuers from the compensation committee listing requirements that apply to issuers listing equity securities.[76] In addition, Exchange Act Rule 3a12-11 exempts listed debt securities from most of the requirements in our proxy and information statement rules.[77] Finally, most, if not all,

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[74] See http://www.house.gov/apps/list/press/financialsvcs_dem/press_072809.shtml.

[75] Although Section 10C is, in many respects, similar to Section 10A(m), there are differences in some of the statutory language. In this regard, we note that the audit committee independence requirements included in Section 10A(m) of the Exchange Act, as set forth in Section 301 of the Sarbanes-Oxley Act, are applicable generally to "listed securities," and no reference is made to equity securities. Therefore, although Section 10A(m) applies to issuers whether they have listed debt or equity, we do not believe this should necessarily prescribe the scope of Section 10C.

[76] See NYSE Listed Company Manual Section 303A.00.

[77] In adopting this rule, the Commission determined that debt holders would receive sufficient protection from the indenture contract, the Trust Indenture Act, the proxy rules' antifraud proscriptions, and the Exchange Act rules that

issuers with only listed debt securities, other than foreign private issuers, are privately held.[78] Thus, subjecting issuers of such securities to the requirements of proposed Rule 10C-1 would not serve the general intent of the Act's executive compensation provisions of protecting "shareholders in a public company."[79] In light of the legislative history and our and the exchanges' historical approach to issuers with only listed debt securities, we believe the new listing standards required by Section 10C are intended to apply only to issuers with listed equity securities.

Request for Comment

- We read Section 10C as applying only to issuers with listed equity securities, and our proposed rules are consistent with that view. Should we instead mandate that the requirements of Sections 10C(b) through (e) be applied to a broader range of issuers, including issuers with only listed debt securities or issuers with other types of listed securities? Why or why not?

b. Securities Futures Products and Standardized Options

The Exchange Act's definition of "equity security" includes any security future on any stock or similar security.[80] The Commodity Futures Modernization Act of 2000 (the "CFMA")[81]

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facilitate the transmission of materials to beneficial owners. See Exemptive Relief and Simplification of Filing Requirements for Debt Securities To Be Listed on a National Securities Exchange, Release No. 34-34922 (Nov. 1, 1994) [59 FR 55342].

[78] Based on information reported in the most recent annual reports on Forms 10-K, 20-F and 40-F that are available on EDGAR, and current public quotation and trade data on issuers whose debt securities are listed on an exchange, such as the NYSE Listed and Traded Bonds and NYSE Amex Listed Bonds, we estimate that there are approximately 76 issuers that list only debt securities on an exchange. Of these 76 issuers, approximately 21 are wholly-owned subsidiaries that would be exempt from proposed Exchange Act Rule 10C-1 pursuant to Section 10C(g) of the Act. None of these 76 issuers has a class of equity securities registered under Section 12 of the Exchange Act.

[79] See H.R. Rep. No. 111-517, Joint Explanatory Statement of the Committee of Conference, Title IX, Subtitle E "Accountability and Executive Compensation," at 872 (Conf. Rep.) (June 29, 2010) ("In this subtitle, Congress provides shareholders in a public company with a vote on executive compensation and additional disclosures regarding compensation practices.").

[80] Exchange Act Section 3(a)(11).

permits national securities exchanges registered under Section 6 of the Exchange Act[82] and national securities associations registered under Section 15A(a) of the Exchange Act[83] to trade futures on individual securities and on narrow-based security indices ("security futures")[84] without such securities being subject to the registration requirements of the Securities Act of 1933 (the "Securities Act") and Exchange Act so long as they are cleared by a clearing agency that is registered under Section 17A of the Exchange Act[85] or that is exempt from registration under Section 17A(b)(7)(A) of the Exchange Act. In December 2002, we adopted rules to provide comparable regulatory treatment for standardized options.[86]

The clearing agency for security futures products and standardized options is the issuer of these securities,[87] but its role as issuer is fundamentally different from an issuer of common stock of an operating company. The purchaser of these securities does not, except in the most formal sense, make an investment decision regarding the clearing agency. As a result, information

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[81] Pub. L. No. 106-554, 114 Stat. 2763 (2000).

[82] 15 U.S.C. 78f.

[83] 15 U.S.C. 78o-3(a).

[84] Exchange Act Section 3(a)(56) [15 U.S.C. 78c(a)(56)], and Commodities Exchange Act Section 1a(32) [7 U.S.C. 1a(32)] define "security futures product" as a security future or any put, call, straddle, option, or privilege on any security future.

[85] 15 U.S.C. 78q-1.

[86] See Release No. 33-8171 (Dec. 23, 2002) [68 FR 188]. In that release, we exempted standardized options issued by registered clearing agencies and traded on a registered national securities exchange or on a registered national securities association from all provisions of the Securities Act, other than the antifraud provision of Section 17, as well as the Exchange Act registration requirements. Standardized options are defined in Exchange Act Rule 9b-1(a)(4) [17 CFR 240.9b-1(a)(4)] as option contracts trading on a national securities exchange, an automated quotation system of a registered securities association, or a foreign securities exchange which relate to option classes the terms of which are limited to specific expiration dates and exercise prices, or such other securities as the Commission may, by order, designate.

[87] See Fair Administration and Governance of Self-Regulatory Organizations; Disclosure and Regulatory Reporting by Self-Regulatory Organizations; Recordkeeping Requirements for Self-Regulatory Organizations; Ownership and Voting Limitations for Members of Self-Regulatory Organizations; Ownership Reporting Requirements for Members of Self-Regulatory Organizations; Listing and Trading of Affiliated Securities by a Self-Regulatory Organization, Release No. 34-50699 (Nov. 18, 2004) [69 FR 71126], at n. 260 ("Standardized options and security futures products are issued and guaranteed by a clearing agency. Currently, all standardized options and security futures products are issued by the Options Clearing Corporation ('OCC').").

about the clearing agency's business, its officers and directors and its financial statements is less relevant to investors in these securities than information about the issuer of the underlying security. Similarly, the investment risk in these securities is determined by the market performance of the underlying security rather than the performance of the clearing agency, which is a self-regulatory organization subject to regulatory oversight. Furthermore, unlike a conventional issuer, the clearing agency does not receive the proceeds from sales of security futures products or standardized options.[88]

In recognition of these fundamental differences, the Commission provided exemptions for security futures products and standardized options when it adopted the audit committee listing requirements in Exchange Act Rule 10A-3.[89] Specifically, Rule 10A-3(c) exempts the listing of a security futures product cleared by a clearing agency that is registered pursuant to Section 17A of the Exchange Act or that is exempt from registration pursuant to Section 17A(b)(7)(A) and the listing of a standardized option issued by a clearing agency that is registered pursuant to Section 17A of the Exchange Act. For the same reasons that we exempted these securities from Rule 10A-3, we propose to exempt these securities from Rule 10C-1, as we believe that there would be no benefit to investors or to the public interest in subjecting the issuers of these securities to the requirements of proposed Rule 10C-1.

Request for Comment

- Is our proposed exemption for securities futures products and standardized options necessary or appropriate in the public interest and consistent with the protection of investors?

[88] However, the clearing agency may receive a clearing fee from its members.

[89] See Exchange Act Rules 10A-3(c)(4) and (5).

- Alternatively, would it further the goal of investor protection to adopt Rule 10C-1 without the proposed exemption for securities futures products and standardized options?

3. Exemptions

a. General Approach to Exemptions

Section 10C of the Exchange Act has four different provisions relating to exemptions from some or all of the requirements of Section 10C:

- Section 10C(a)(1) provides that our rules shall direct the exchanges to prohibit the listing of any equity security of an issuer, other than an issuer that is in one of five specified categories, that is not in compliance with the compensation committee member independence requirements of Section 10C(a)(2);
- Section 10C(a)(4) provides that our rules shall authorize the exchanges to exempt a particular relationship from the independence requirements applicable to compensation committee members, as each exchange determines is appropriate, taking into consideration the size of the issuer and other relevant factors;
- Section 10C(f)(3) provides that our rules shall authorize the exchanges to exempt any category of issuer from the requirements of Section 10C, taking into account the potential impact of the requirements on smaller reporting companies;[90] and

[90] Exchange Act Rule 12b-2 defines "smaller reporting company" as "an issuer that is not an investment company, an asset-backed issuer . . ., or a majority-owned subsidiary of a parent that is not a smaller reporting company and that: (1) Had a public float of less than $75 million as of the last business day of its most recently completed second fiscal quarter, computed by multiplying the aggregate worldwide number of shares of its voting and non-voting common equity held by non-affiliates by the price at which the common equity was last sold, or the average of the bid and asked prices of common equity, in the principal market for the common equity; or (2) In the case of an initial registration statement under the Securities Act or Exchange Act for shares of its common equity, had a public float of less than $75 million as of a date within 30 days of the date of the filing of the registration statement, computed by multiplying the aggregate worldwide number of such shares held by non-affiliates before the registration plus, in the case of a Securities Act registration statement, the number of such shares included in the registration statement by the estimated public offering price of the shares; or (3) In the case of an issuer whose

- Section 10C(g) specifically exempts controlled companies, as defined in Section 10C(g), from all of the requirements of Section 10C.

We can exempt any person, security or transaction, or any class or classes of person, securities or transactions, from any of the requirements of the Exchange Act, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.[91] In addition, as noted above, Section 10C(f)(3) provides that our rules shall authorize the exchanges to exempt any category of issuers from the requirements of Section 10C.[92] As with any listing standards, listing standards implementing this provision would be subject to Commission review pursuant to Section 19(b) of the Exchange Act. In view of this statutory approach, we are preliminarily of the view that it should be up to the exchanges to propose the categories of issuers to be exempted from Section 10C's requirements, subject to our review in the rule filing process. Because issuers frequently consult the exchanges regarding independence determinations and committee responsibilities, the exchanges may be in the best position to identify the types of common relationships that are likely to compromise the ability of an issuer's compensation committee to make impartial determinations on executive compensation and the types of issuers that should be exempted from the other compensation committee listing requirements. Accordingly, relying on the exchanges to exercise their exemptive authority under our rules may result in more efficient and effective determinations as

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public float as calculated under paragraph (1) or (2) of this definition was zero, had annual revenues of less than $50 million during the most recently completed fiscal year for which audited financial statements are available." Whether or not an issuer is a smaller reporting company is determined on an annual basis.

[91] See Exchange Act Section 36.

[92] We are proposing to implement Section 10C(c)(2)'s compensation consultant disclosure requirements by amending Item 407(e)(3) of Regulation S-K. See Section II.C., below, for a discussion of these proposed amendments. Because Item 407 of Regulation S-K is not part of Section 10C, Section 10C(f)(3) would not permit exchanges to exempt any category of issuers from our proposed revisions to Item 407, if adopted. We request comment below on whether smaller reporting companies should be exempt from our proposed disclosure requirements in the event the exchanges exempt such companies from the listing standards required by Section 10C.

to the types of relationships and the types of issuers that merit an exemption, whether in whole or in part, from the requirements of Section 10C.

We note that Section 10C of the Exchange Act makes no distinction between domestic and foreign issuers, other than to exempt from the independence requirements foreign private issuers that disclose in their annual reports the reasons why they do not have independent compensation committees. Many listed foreign private issuers maintain compensation committees, and other than the committee member independence requirements in proposed Rule 10C-1(b)(1), the proposed rule and rule amendments, therefore, would apply to foreign private issuers as well as domestic issuers.

Because the exchanges will be permitted to propose exemptions to the listing standards required by Section 10C and our rules, we do not propose to exempt any category of issuer or any relationship from rules implementing Section 10C, other than the five categories of issuers not subject to the compensation committee independence requirements, as directed by Section 10C(a)(1), securities futures products and standardized options, as discussed above in Section II.B.2.b, and the equity securities of controlled companies, as directed by Section 10C(g).

Instead of providing exemptions in our rules, consistent with Section 10C(f)(3), proposed Rule 10C-1(b)(5)(i) permits the exchanges to exempt a category of issuers from the requirements of Section 10C, as each exchange determines is appropriate. In determining appropriate exemptions, the exchanges are required by the statute to take into account the potential impact of the requirements of Section 10C on smaller reporting issuers.[93]

[93] See Exchange Act Section 10C(f)(3)(B). Section 10C of the Exchange Act includes no express exemptions for smaller reporting companies. We note that neither NYSE nor Nasdaq currently exempts smaller reporting companies from their corporate governance requirements. Other than limited exemptions from requirements to have a majority independent board or three-member audit committee – for example, NYSE Amex and the Chicago Stock Exchange permit smaller issuers to have a 50% independent board and a minimum of two members on the issuer's audit committee – we are unaware of any corporate governance listing standards or related exemptions that are tailored to smaller reporting companies. See NYSE Amex Company Guide Section 801(h); Chicago Stock

Request for Comment

- Should the Commission exempt any types of issuers, such as registered management investment companies, foreign private issuers or smaller reporting companies, from some or all of the requirements of Section 10C? If so, why? Instead, should the Commission, as proposed, defer to the exchanges for exemptions from Section 10C's requirements, rather than propose and adopt exemptions in our rules?
- Should the Commission issue additional guidance to the exchanges as to the factors that should weigh in favor of granting exemptions? What concerns, if any, should the Commission be aware of in reviewing exemptions proposed by the exchanges?
- Rather than exempt any category of issuers, should the Commission require the exchanges to give additional time to certain types of issuers to comply with the requirements of Section 10C, such as companies that have just completed initial public offerings? Or, should we defer to the exchanges to provide temporary exemptions, as proposed?

b. Issuers Not Subject to Independence Requirements

As noted above, Exchange Act Section 10C(a)(1) provides that our rules shall direct the exchanges to prohibit the listing of any equity security of an issuer, other than an issuer that is in one of five specified categories, that is not in compliance with the compensation committee member independence requirements of Section 10C(a)(2). These five categories include controlled companies, limited partnerships, companies in bankruptcy proceedings, open-end

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Exchange Article 22, Rules 19(a), 19(b)(1)(C)(iii), and 21(a). Section 10C(f)(3) requires the exchanges to take into account the potential impact of the listing requirements on smaller reporting issuers when exercising the exemptive authority permitted by our rules. Any such exemptions, rule changes and any other new listing requirements would be subject to Commission approval through the rule submission process under Section 19(b) of the Exchange Act.

management investment companies registered under the Investment Company Act[94] and foreign private issuers that provide annual disclosures to shareholders of the reasons why the foreign private issuer does not have an independent compensation committee. Accordingly, proposed Rule 10C-1(b)(1)(iii) provides that these five categories of issuers are not subject to an exchange's compensation committee independence requirements and, therefore, an issuer that is in one of these categories cannot be delisted for not complying with such requirements.

Controlled Companies

Section 10C(g)(2) of the Exchange Act defines "controlled company" as an issuer that is listed on an exchange and holds an election for the board of directors of the issuer in which more than 50 percent of the voting power is held by an individual, a group or another issuer. Proposed Rule 10C-1(c)(2) would incorporate this definition of "controlled company."

Limited Partnerships

Section 10C does not define the term "limited partnerships." In general, a limited partnership is a form of business ownership and association consisting of one or more general partners who are fully liable for the debts and obligations of the partnership and one or more limited partners whose liability is limited to the amount invested.[95] We do not propose to define this term in proposed Rule 10C-1(c), although we solicit comment on whether we should do so.

Companies in Bankruptcy Proceedings

Section 10C does not define the scope of "companies in bankruptcy proceedings." This term is used in Commission rules without definition.[96] We do not propose to define the scope of

[94] 15 U.S.C. 80a-1 et seq.

[95] See Unif. Ltd. P'ship Act §§ 102, 303 and 404 (2001).

[96] See, e.g., Section 55(a)(3)(A) of the Investment Company Act [15 U.S.C. 80a-54(a)(3)(A)]; Item 1107(k) of Regulation AB [17 CFR 229.1107(k)]; and Rule 457 under the Securities Act [17 CFR 230.457].

"companies in bankruptcy proceedings," although we solicit comment on whether we should do so.

Open-End Management Investment Companies

Section 10C does not define the term "open-end management investment company." Under the Investment Company Act, an open-end management investment company is an investment company, other than a unit investment trust or face-amount certificate company, that offers for sale or has outstanding any redeemable security of which it is the issuer.[97] We propose to define this term by referencing Section 5(a)(1) of the Investment Company Act.

Foreign Private Issuers

Under Section 10C(a), a foreign private issuer that provides annual disclosure to shareholders of the reasons why the foreign private issuer does not have an independent compensation committee would be exempt from the compensation committee independence requirements. Exchange Act Rule 3b-4 defines "foreign private issuer" as "any foreign issuer other than a foreign government, except for an issuer that has more than 50% of its outstanding voting securities held of record by U.S. residents and any of the following: a majority of its officers and directors are citizens or residents of the United States, more than 50% of its assets are located in the United States, or its business is principally administered in the United States."[98] Since this definition applies to all Exchange Act rules, we do not believe it is necessary to provide a cross-reference to Rule 3b-4 in our proposed rules.

[97] See Sections 4 and 5(a)(1) of the Investment Company Act [15 U.S.C. 80a-4 and 80a-5(a)(1)]. Open-end and closed-end management investment companies registered under the Investment Company Act are generally exempt from current exchange listing standards that require listed issuers to either have a compensation committee or to have independent directors determine, recommend, or oversee specified executive compensation matters. See, e.g., NYSE Listed Company Manual Section 303A.00; Nasdaq Rule 5615(a)(5); NYSE Arca Rule 5.3; NYSE AMEX LLC Company Guide Section 801.

[98] 17 CFR 240.3b-4(c).

We note that certain foreign private issuers have a two-tier board, with one tier designated as the management board and the other tier designated as the supervisory or non-management board. In this circumstance, we believe that the supervisory or non-management board would be the body within the company best equipped to comply with the proposed requirements. Consistent with our approach to Rule 10A-3, we propose to clarify that in the case of foreign private issuers with two-tier boards of directors, the term "board of directors" means the supervisory or non-management board. As such, to the extent the supervisory or non-management board forms a separate compensation committee, proposed Rule 10C-1 would apply to that committee, with the exception of the committee member independence requirements, assuming the foreign private issuer discloses why it does not have an independent compensation committee in its annual report.

Request for Comment

- Should we provide a definition of "limited partnership" in our proposed rules? If so, what should it be?
- Should we define the scope of "companies in bankruptcy proceedings"? If so, what should that scope be?
- Do we need to clarify, as proposed, that in the case of foreign private issuers with two-tier boards of directors, the term "board of directors" means the supervisory or non-management board?

c. Relationships Exempt from Independence Requirements

As noted above, Section 10C(a)(4) of the Exchange Act provides that the Commission's rules shall permit an exchange to exempt a particular relationship from the compensation committee independence requirements, as such exchange deems appropriate, taking into consideration the size of the issuer and any other relevant factors.[99] To implement this provision, proposed Rule 10C-1(b)(1)(iii)(B) would authorize the exchanges to establish listing standards under the Section 19(b) process that exempt particular relationships between members of the compensation committee and listed issuers that might otherwise impair the member's independence, taking into consideration the size of an issuer and any other relevant factors.

We do not propose to exempt any particular relationships from the independence requirements at this time. As with the authority to exempt particular categories of issuers, we are preliminarily of the view that it should be up to the exchanges to identify and propose the types of particular relationships that should be exempted from the independence requirements.

Request for Comment

- Should the Commission, as proposed, defer to the exchanges to identify and propose the types of particular relationships to be exempted from the independence requirements? If not, why not?
- Should we give guidance to the exchanges on how they should analyze relationships to determine whether an exemption is warranted or not?
- Some of the exchanges, in their existing compensation committee listing standards, permit a listed issuer with a compensation committee comprised of at least three members to include one director who is not independent and is not a current officer or employee, or immediate family member of a current officer or employee, on the compensation committee for no more than two years if the issuer's board, under exceptional and limited circumstances, determines that such individual's membership on the committee is required in the best interests of the company and its

[99] See Exchange Act Section 10C(a)(4).

shareholders.[100] Should our proposed rule expressly permit the exchanges to continue this practice by exempting certain relationships from the independence requirements, based on the conditions outlined above? Should our proposed rule expressly prohibit the exchanges from continuing this practice?

- What issues should an exchange consider in proposing an exemption?
- Exchange Act Rule 10A-3 requires listed issuers that avail themselves of an exemption from the audit committee independence requirements to disclose such reliance on an exemption in the listed issuer's proxy statement and Form 10-K or, in the case of a registered management investment company, Form N-CSR. Should we similarly require any issuer availing itself of any of the exemptions set forth directly in Section 10C(a)(1) of the Exchange Act or any exemption granted by the relevant exchange to disclose that fact in its proxy statement and Form 10-K or, in the case of a registered management investment company, Form N-CSR or another form? Under current rules, an issuer is required to identify any compensation committee members who are not independent. In light of this requirement, is a specific requirement to note reliance on an exemption unnecessary?
- If a listed issuer's board of directors determines, in accordance with applicable listing standards, to appoint a director to the compensation committee who is not independent, including as a result of exceptional or limited or similar circumstances, should we require the issuer to disclose the nature of the relationship that makes that individual not independent and the reasons for the board of directors' determination,

[100] See NYSE Amex LLC Company Guide, Section 805(b); NYSE Arca Rule 5.3(k)(4); Nasdaq Rule 5605(d)(3); NASDAQ OMX BX Rule 4350(c)(3)(C); Chicago Board Options Exchange Rule 31.10(c)(3); and Chicago Stock Exchange Article 22, Rule 19(d)(3).

as we do with respect to audit committee members in Item 407(d)(2) of Regulation S-K?

C. Compensation Consultant Disclosure and Conflicts of Interest

Section 10C(c)(2) of the Exchange Act requires that, in any proxy or consent solicitation material for an annual meeting (or a special meeting in lieu of the annual meeting), each issuer must disclose, in accordance with regulations of the Commission, whether:

- the compensation committee has retained or obtained the advice of a compensation consultant; and
- the work of the compensation consultant has raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed.

Item 407 of Regulation S-K currently requires Exchange Act registrants that are subject to the proxy rules to provide certain disclosures concerning their compensation committees and the use of compensation consultants.[101] Item 407(e)(3)(iii) generally requires registrants to disclose "any role of compensation consultants in determining or recommending the amount or form of executive and director compensation," including:

- identifying the consultants;
- stating whether such consultants were engaged directly by the compensation committee or any other person;
- describing the nature and scope of the consultants' assignment, and the material elements of any instructions given to the consultants under the engagement; and

[101] Registered investment companies are subject to separate proxy disclosure requirements set forth in Item 22 of Schedule 14A, which do not include the compensation committee disclosure described in Item 407(e) of Regulation S-K. See Item 7(g) of Schedule 14A. Consistent with our current regulations, registered investment companies would continue to provide disclosure under Item 22 and would not be subject to the amendments to Item 407(e) proposed in this release.

- disclosing the aggregate fees paid to a consultant for advice or recommendations on the amount or form of executive and director compensation and the aggregate fees for additional services if the consultant provided both and the fees for the additional services exceeded $120,000 during the fiscal year.[102]

The current item excludes from the disclosure requirement any role of compensation consultants limited to consulting on any broad-based plan that does not discriminate in scope, terms or operation in favor of executive officers or directors of the registrant and that is available generally to all salaried employees, or limited to providing information that either is not customized for a particular registrant or is customized based on parameters that are not developed by the compensation consultant, and about which the compensation consultant does not provide advice.[103]

Given the similarities between the disclosure required by Section 10C(c)(2) and the disclosure required by Item 407 of Regulation S-K for registrants subject to our proxy rules, we propose to integrate Section 10C(c)(2)'s disclosure requirements with the existing disclosure rule, rather than simply "tacking on" the new requirements to the existing ones. Section 10C(c)(2) specifies that these disclosures are to be required "in any proxy or consent solicitation material for an annual meeting of the shareholders (or a special meeting in lieu of the annual meeting)." By contrast, our proxy rules currently require issuers to provide disclosure relating to the retention of a compensation consultant and fees paid to consultants only in proxy or

[102] See current Items 407(e)(3)(iii)(A) and (B) [17 CFR 229.407(e)(3)(iii)(A) and 229.407(e)(3)(iii)(B)]. Fee disclosure, however, is not required for compensation consultants that work with management if the compensation committee has retained a separate consultant. In promulgating these requirements, we recognized that in this situation the compensation committee may not be relying on the compensation consultant used by management, and, therefore, potential conflicts of interest are less of a concern.

[103] See Proxy Disclosure Enhancements, Release No. 33-9089 (Dec. 16, 2009) [74 FR 68334]. The Commission determined (based on comments it received on the rule proposal) that the provision of such work by a compensation consultant does not raise conflict of interest concerns that warrant disclosure of the consultant's selection, terms of engagement or fees.

information statements for annual meetings at which directors are to be elected, and not for all annual meetings. However, Section 10C(c)(2) also provides that the compensation consultant disclosures be made "in accordance with regulations of the Commission." Because we view this disclosure as being most relevant in the context of a meeting at which directors will be elected, consistent with our current rules, we propose to require Section 10C(c)(2)'s compensation consultant and conflict of interest disclosure only for proxy and information statements for annual meetings (or a special meeting in lieu of an annual meeting) at which directors are to be elected.

Section 10C(f) of the Exchange Act requires us to adopt rules directing the exchanges to prohibit the listing of any security of an issuer that is not in compliance with the requirements of Section 10C, which include Section 10C(c)(2)'s disclosure requirements. Consequently, we are required to extend these disclosure requirements to listed issuers other than controlled companies,[104] but we are not required to extend them to all Exchange Act registrants subject to our proxy rules. However, given the similar nature of the disclosure required by current Item 407(e) and Section 10C(c)(2) and the apparent common purpose of these disclosure requirements, and to avoid any potential confusion that could arise from having different disclosure requirements on the same topic for listed issuers on one hand and for unlisted issuers and controlled companies on the other, we propose to combine the current Item 407(e) and Section 10C(c)(2) into one disclosure requirement that would apply to Exchange Act registrants subject to our proxy rules, whether listed or not, whether they are controlled companies or not.

We note that the trigger for disclosure about compensation consultants under Section 10C(c)(2) of the Exchange Act is worded differently from the trigger for disclosure under the

[104] Section 10C(g) specifically exempts controlled companies, as defined in Section 10C(g), from all of the requirements of Section 10C. Controlled companies are subject to our existing Item 407(e)(3) disclosure requirements.

amendments to Item 407 that we adopted in 2009.[105] Specifically, Section 10C(c)(2) states that the issuer must disclose whether the "compensation committee retained or obtained the advice of a compensation consultant." By contrast, as noted above, our current rule refers to whether compensation consultants played "any role" in the registrant's process for determining or recommending the amount or form of executive or director compensation. Once disclosure is required, the specifics of what must be disclosed are also different. With regard to conflicts of interest, our current rule requires detailed disclosure about fees in certain circumstances in which there may be a conflict of interest, whereas Section 10C(c)(2) is more open-ended and requires disclosure of any conflict of interest, the nature of the conflict and how the conflict is being addressed, which our existing rules do not require.

As proposed, revised Item 407(e)(3)(iii) would have a disclosure trigger that is consistent with the statutory language and would, therefore, require the registrant to disclose whether the compensation committee has "retained or obtained" the advice of a compensation consultant during the registrant's last completed fiscal year. We anticipate that the practical effect of the proposed change would be minimal, as we believe it would be unusual for a consultant to play a role in determining or recommending the amount of executive compensation without the compensation committee also retaining or obtaining the consultant's advice. And, we believe having a consistent trigger for disclosure would benefit issuers and investors by reducing potential confusion about the disclosure requirements.

Consistent with Section 10C(c)(2), disclosure of whether the compensation committee obtained or retained the advice of a compensation consultant during the registrant's last completed fiscal year and whether the consultant's work raised any conflict of interest and, if so,

[105] Id.

the nature of the conflict and how it is being addressed, would be required without regard to the existing exceptions in Item 407(e)(3). For example, disclosure about the compensation consultant would be required even if the consultant provides only advice on broad-based plans or provides only non-customized benchmark data. In this regard, we would be broadening the scope of disclosure currently required by Item 407(e)(3)(iii). We believe this is consistent with the purposes of Section 10C(c)(2), which is to require disclosure about compensation consultants and any conflicts of interest they have in a competitively neutral fashion. We solicit comment, however, on whether any of the current exclusions should extend to this new disclosure requirement or, conversely, whether we should eliminate the exclusions with respect to the existing disclosure requirements. We also solicit comment on whether it would be preferable to retain the existing requirements without modification and add the new requirements without integrating them into the existing ones.

The other existing disclosure requirements of Item 407(e)(3) would remain the same, aside from amending the fee disclosure requirements to link the disclosure of fees to the compensation committee "retaining or obtaining the advice of a compensation consultant" and to management "retaining or obtaining the advice of a compensation consultant."[106] The disclosure of the aggregate fees paid to a compensation consultant is intended to enable security holders to assess the potential for conflicts of interest resulting from the compensation consultant's financial incentive to provide services to the issuer in addition to executive compensation consulting services. We believe that this disclosure benefits investors and complements the required Section 10C(c)(2) disclosures, and therefore propose to retain this existing disclosure requirement, modified as noted above.

[106] See proposed Items 407(e)(3)(iii)(A) and (B). The fee disclosure requirements would continue to include the existing exclusions for consulting on any non-discriminatory, broad-based plan or providing non-customized information.

To provide guidance to issuers as to whether the compensation committee or management has "obtained the advice" of a compensation consultant,[107] we are proposing an instruction to clarify this statutory language. This instruction would provide that the phrase "obtained the advice" relates to whether a compensation committee or management has requested or received advice from a compensation consultant, regardless of whether there is a formal engagement of the consultant or a client relationship between the compensation consultant and the compensation committee or management or any payment of fees to the consultant for its advice.

Currently, Item 407(e)(3) focuses on the conflicts of interest that may arise from a compensation consultant also providing other non-executive compensation consulting services to an issuer, which may lead the consultant to provide executive compensation advice favored by management in order to obtain or retain such other assignments. Section 10C(c)(2) is more open-ended about conflicts of interest in that it requires issuers to disclose whether the work of a compensation consultant raised "any conflict of interest" and, if so, the nature of the conflict and how the conflict is being addressed. The term "conflict of interest" is not defined in Section 10C(c)(2), and our proposed rule would not supply a definition.

As discussed above, Sections 10C(f) and 10C(b) of the Exchange Act require the Commission to adopt rules directing the exchanges to prohibit the listing of the securities of an issuer whose compensation committee does not consider the independence factors identified by the Commission when retaining compensation advisers. Section 10C(b)(2) identifies specific

[107] See letter from Compensia.

factors that must be included in these listing standards, and, as described above, we are proposing to include them in proposed Rule 10C-1(b)(4)(i) through (v).[108]

In light of the link between the requirement that the compensation committees of listed issuers consider independence factors before retaining compensation advisers and the disclosure requirements about compensation consultants and their conflicts of interest, we believe it would be appropriate to provide some guidance to issuers as to the factors that should be considered in determining whether there is a conflict of interest that would trigger disclosure under the proposed amendments. Therefore, we propose to include an instruction that identifies the factors set forth in proposed Rule 10C-1(b)(4)(i) through (v) as among the factors that issuers should consider in determining whether there is a conflict of interest that may need to be disclosed in response to our proposed amendments to Item 407(e)(3)(iii). Although only listed issuers will be required to consider the five independence factors before selecting a compensation consultant, we believe that these five factors will be helpful to all Exchange Act registrants subject to the proxy rules in assessing potential conflicts of interest.

We have not concluded that the presence or absence of any of these individual factors indicates that a compensation consultant has a conflict of interest that would require disclosure under the proposed amendments, nor have we concluded that there are no other circumstances or factors that might present a conflict of interest for a compensation consultant retained by a compensation committee. Moreover, if, under our rules, disclosure of fees paid to a compensation consultant is required, this does not reflect a conclusion that a conflict of interest is present.[109] In addition to considering the factors enumerated above and any other factors that the

[108] See Section II.A.4, above, for a description of proposed Rule 10C-1(b)(4)(i) through (v).

[109] See Proxy Disclosure Enhancements, Release No. 33-9089 (Dec. 16, 2009) [74 FR 68334] ("Our amendments as adopted are intended to facilitate investors' consideration of whether, in providing advice, a

exchanges may highlight in applicable listing standards, the issuer would need to consider the specific facts and circumstances relating to a consultant's engagement to determine whether there may be a conflict of interest that would be required to be disclosed under our new rules.

If a compensation committee determines that there is a conflict of interest with the compensation consultant based on the relevant facts and circumstances, the issuer would be required to provide a clear, concise and understandable description of the specific conflict and how the issuer has addressed it. A general description of an issuer's policies and procedures to address conflicts of interest or the appearance of conflicts of interest would not suffice.

Request for Comment

- We request comment on our proposed implementation of the requirements of Section 10C(c)(2). Is it appropriate to limit Section 10C(c)(2)'s disclosure requirement to proxy and information statements for meetings at which directors are to be elected? If not, why not? Is it appropriate to extend Section 10C(c)(2)'s disclosure requirement to controlled companies and those Exchange Act registrants that are not listed issuers, as proposed? If not, why not?
- Should we amend Forms 20-F and 40-F to require foreign private issuers that are not subject to our proxy rules to provide annual disclosure of the type required by Section 10C(c)(2)? Why or why not?

compensation consultant may have been influenced by a desire to retain other engagements from the company. This does not reflect a conclusion that we believe that a conflict of interest is present when disclosure is required under our new rule, or that a compensation committee or a company could not reasonably conclude that it is appropriate to engage a consultant that provides other services to the company requiring disclosure under our new rule.").

- Is it preferable to integrate the Section 10C(c)(2) disclosure requirements with the existing requirements of Item 407(e)(3), as proposed, or, instead, should we add the new requirements without modifying the existing requirements of the item?
- Should we extend any of the current exclusions under Item 407(e)(3) to the new Section 10C(c)(2) disclosures? Conversely, should we eliminate altogether the exclusions under Item 407(e)(3)?
- Are there any additional disclosures concerning conflicts of interest involving the activities of compensation consultants that would be beneficial to investors?
- Is additional clarification necessary regarding the phrase "obtained the advice"? Does our proposed instruction provide adequate guidance to issuers on how to interpret that phrase?
- Do the five factors in proposed Rule 10C-1(b)(4)(i) through (v) help issuers determine whether there is a "conflict of interest"? Should we define the term "conflict of interest"? If so, how? Are there other factors that should be considered in determining whether there is a conflict of interest? If so, should these factors also be identified in the proposed instruction?
- Because a compensation committee may be reluctant or unable to definitively conclude whether a conflict of interest exists, should we also include the appearance of a conflict of interest in our interpretation of what constitutes a "conflict of interest" that must be disclosed under our proposed rules? Why or why not? Should we include potential conflicts of interest in our interpretation? Why or why not? We note that our 2009 amendments to Item 407(e) did not conclude that there was a

conflict of interest posed by a consultant providing additional services to the issuer, only that there was a potential conflict of interest.

- Should we should require fee disclosure for other types of potential conflicts of interest, such as revenue concentration, in light of Section 10C(c)(2)'s requirement that the factors considered by the compensation committee before engaging compensation advisers be "competitively neutral"? For example, to address revenue concentration, we could require disclosure of an adviser's fees received from the issuer (in percentage terms) if such fees comprise more than 10% of the adviser's annual revenues. Would this be appropriate?
- Although a listed issuer's compensation committee is required to consider independence factors before selecting any compensation adviser, Section 10C(c)(2) requires conflict of interest disclosure only as to compensation consultants. Should we also extend this disclosure requirement to other types of advisers to the compensation committee, such as legal counsel? Why or why not?
- As proposed, and consistent with current rules, Item 407(e)(3) would apply to smaller reporting companies. Should we exempt such companies from these disclosure requirements? Do many smaller reporting companies' compensation committees retain or obtain the advice of compensation consultants? Should an exemption be provided if the exchanges exempt such companies from the listing standards required by Section 10C?

D. Transition and Timing

The Act requires us to issue rules directing the exchanges to prohibit the listing of issuers not in compliance with Section 10C "not later than 360 days after" the enactment of Section

10C, or by July 16, 2011.[110] The Act did not establish a specific deadline by which the listing standards promulgated by the exchanges must be in effect. To facilitate timely implementation of the proposals, we propose that each exchange must provide to the Commission, no later than 90 days after publication of our final rule in the Federal Register, proposed rules or rule amendments that comply with our final rule. Further, each exchange would need to have final rule or rule amendments that comply with our final rule approved by the Commission no later than one year after publication of our final rule in the Federal Register. We request comment below on the appropriateness of these periods.

Section 10C(c)(2) requires that each issuer disclose in any proxy or consent solicitation material for an annual meeting of shareholders (or a special meeting in lieu of the annual meeting) whether the issuer's compensation committee retained or obtained the advice of a compensation consultant; whether the work of the compensation consultant has raised any conflict of interest; and, if so, the nature of the conflict and how the conflict is being addressed. Although the statute specifies that this disclosure would be required with respect to meetings occurring on or after the date that is one year after the enactment of Section 10C, which would be July 21, 2011, the statute also requires these disclosures to be "in accordance with regulations of the Commission," and our regulations do not currently require such disclosures to be made. Consequently, Section 10C(c)(2)'s compensation consultant and conflict of interest disclosures would not be required for proxy or information statements filed in definitive form before the effective date of our rules implementing Section 10C(c)(2).

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[110] See Section 10C(f)(1) of the Exchange Act [15 U.S.C. 78j-3(f)(1)]. The Act was enacted on July 21, 2010. The 360th day following enactment would be July 16, 2011.

Request for Comment

- Do the proposed implementation dates provide sufficient time for exchanges to propose and obtain Commission approval for new or amended rules to meet the requirements of our proposed rules? If not, what other dates would be appropriate, and why?
- What factors should the Commission consider in determining these dates?
- Should our rules also specify the dates by which listed issuers must comply with an exchange's new or amended rules meeting the requirements of our proposed rules? If so, what dates would be appropriate? Should there be uniformity among the exchanges with respect to the dates by which their listed issuers must comply with the exchanges' new or amended rules?
- Would a period beyond the proposed date be necessary or appropriate for compliance by smaller reporting companies? Are there special considerations that we should take into account for foreign private issuers?

General Request for Comment

We request and encourage any interested person to submit comments on any aspect of our proposals, other matters that might have an impact on the amendments, and any suggestions for additional changes. With respect to any comments, we note that they are of greatest assistance to our rulemaking initiative if accompanied by supporting data and analysis of the issues addressed in those comments and by alternatives to our proposals where appropriate.

III. PAPERWORK REDUCTION ACT

A. Background

Certain provisions of the proposed rule and rule amendments contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 (PRA).[111] We are submitting the proposed rule and rule amendments to the Office of Management and Budget (OMB) for review in accordance with the PRA.[112] The titles for the collection of information are:

(1) "Regulation 14A and Schedule 14A" (OMB Control No. 3235-0059);

(2) "Regulation 14C and Schedule 14C" (OMB Control No. 3235-0057); and

(3) "Regulation S-K" (OMB Control No. 3235-0071).[113]

Regulation S-K was adopted under the Securities Act and Exchange Act; Regulations 14A and 14C and the related schedules were adopted under the Exchange Act. The regulations and schedules set forth the disclosure requirements for proxy and information statements filed by companies to help investors make informed investment and voting decisions. The hours and costs associated with preparing, filing and sending the schedules constitute reporting and cost burdens imposed by each collection of information. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. Compliance with the proposed rule and rule amendments would be mandatory. Responses to the information collections would not be kept confidential and there would be no mandatory retention period for the information disclosed.

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[111] 44 U.S.C. 3501 et seq.

[112] 44 U.S.C. 3507(d) and 5 CFR 1320.11.

[113] The paperwork burden from Regulation S-K is imposed through the forms that are subject to the disclosure requirements in Regulation S-K and is reflected in the analysis of these forms. To avoid a Paperwork Reduction Act inventory reflecting duplicative burdens, for administrative convenience we estimate the burden imposed by Regulation S-K to be a total of one hour.

B. Summary of Proposed Rule and Rule Amendments

As discussed in more detail above, we are proposing new Rule 10C-1 under the Exchange Act and amendments to Item 407(e) of Regulation S-K. Proposed Rule 10C-1 would implement the requirements of Section 10C of the Exchange Act, as added by Section 952 of the Act. Specifically, proposed Rule 10C-1 would direct the exchanges to prohibit the listing of any equity security of an issuer, with certain exemptions, that is not in compliance with Section 10C's compensation committee and compensation adviser requirements. We are proposing to adopt several limited exemptions from the requirements of proposed Rule 10C-1 and to authorize the exchanges to include other exemptions in their listing standards, pursuant to the rule filing process under Section 19(b) of the Exchange Act, as each exchange determines is appropriate, taking into consideration the size of the issuer and any other relevant factors.

To implement Section 10C(c)(2), we are proposing to amend Item 407(e)(3) of Regulation S-K to require disclosure, in any proxy or information statement relating to an annual meeting of shareholders (or a special meeting in lieu of an annual meeting) at which directors are to be elected, of whether the issuer's compensation committee (or another board committee performing similar functions) retained or obtained the advice of a compensation consultant; whether the work of the compensation consultant has raised any conflict of interest; and, if so, the nature of the conflict and how the conflict is being addressed.[114] We also propose to combine and streamline these disclosure requirements with the existing disclosure requirements of Item 407(e)(3).

[114] Section 10C(c)(2) requires listed issuers to provide this disclosure; we propose to extend this disclosure requirement to non-listed issuers as well. We have not, however, proposed to require comparable disclosure from foreign private issuers, as foreign private issuers are not subject to Exchange Act Sections 14(a) and 14(c). See Exchange Act Rule 3a12-3.

C. Burden and Cost Estimates Related to the Proposed Amendments

The proposed amendments to Item 407(e)(3) of Regulation S-K would require, if adopted, additional disclosure in proxy or information statements filed on Schedule 14A or Schedule 14C relating to an annual meeting of shareholders (or a special meeting in lieu of an annual meeting) at which directors are to be elected and would increase the burden hour and cost estimates for each of those forms. For purposes of the PRA, we estimate the total annual increase in the paperwork burden for all affected issuers to comply with our proposed collection of information requirements to be approximately 23,940 hours of in-house personnel time and approximately $3,192,000 for the services of outside professionals.[115] These estimates include the time and the cost of collecting the information, preparing and reviewing disclosure, filing documents, and retaining records. In deriving our estimates, we assumed that the burden hours of the proposed disclosure requirements would be comparable to the burden hours related to similar disclosure requirements under our current rules regarding compensation consultants.[116] Based on our assumptions, we estimated that the proposed amendments to Item 407(e)(3)(iii) of Regulation S-K would impose on average four incremental burden hours.[117]

The table below shows the total annual compliance burden, in hours and in costs, of the collection of information pursuant to the proposed amendments to proxy and information statements and to Regulation S-K.[118] The burden estimates were calculated by multiplying the estimated number of responses by the estimated average amount of time it would take an issuer

[115] Our estimates represent the average burden for all issuers, both large and small.

[116] See Proxy Disclosure Enhancements, Release No. 33-9089 (Dec. 16, 2009) [74 FR 68334] (in which the Commission estimated the average incremental disclosure burden for the rule amendments to Item 407(e)(3) relating to compensation consultants to be three hours).

[117] These four incremental burden hours would be in addition to the three incremental burden hours relating to our current compensation consultant disclosure rules. Id.

[118] For convenience, the estimated hour and cost burdens in the table have been rounded to the nearest whole number.

to prepare and review the proposed disclosure requirements. The portion of the burden carried by outside professionals is reflected as a cost, while the portion of the burden carried by the issuer internally is reflected in hours. For purposes of the PRA, we estimate that 75% of the burden of preparation of Schedules 14A and 14C is carried by the issuer internally and that 25% of the burden of preparation is carried by outside professionals retained by the issuer at an average cost of $400 per hour. There is no change to the estimated burden of the collections of information under Regulation S-K because the burdens that this regulation imposes are reflected in our burden estimates for Schedules 14A and 14C.

Table 1. Incremental Paperwork Burden under the proposed amendments for Schedules 14A and 14C.

	Number of responses (A)[119]	Incremental burden hours/form (B)	Total incremental burden hours (C)=(A)*(B)	Internal company time (D)	External professional time (E)	Professional costs (F)=(E)*$400
Sch. 14A	7,300	4	29,200	21,900	7,300	$2,920,000
Sch. 14C	680	4	2,720	2,040	680	$272,000
Total	7,980		31,920	23,940	7,980	$3,192,000

D. Request for Comment

Pursuant to 44 U.S.C. 3506(c)(2)(B), we request comment in order to:

- Evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility;
- Evaluate the accuracy of our assumptions and estimates of the burden of the proposed collections of information;
- Determine whether there are ways to enhance the quality, utility and clarity of the information to be collected;

[119] The number of responses reflected in the table equals the actual number of schedules filed with the Commission during the 2010 fiscal year.

- Evaluate whether there are ways to minimize the burden of the collections of information on those who respond, including through the use of automated collection techniques or other forms of information technology; and
- Evaluate whether the proposed amendments will have any effects on any other collections of information not previously identified in this section.

Any member of the public may direct to us any comments concerning the accuracy of these burden estimates and any suggestions for reducing these burdens. Persons submitting comments on the collection of information requirements should direct their comments to the Office of Management and Budget, Attention: Desk Officer for the U.S. Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and send a copy to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, with reference to File No. S7-13-11. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-13-11 and be submitted to the U.S. Securities and Exchange Commission, Office of Investor Education and Advocacy, 100 F Street NE, Washington DC 20549-0213. Because the OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this release, your comments are best assured of having their full effect if the OMB receives them within 30 days of publication.

IV. COST-BENEFIT ANALYSIS

A. Introduction and Objectives of Proposals

We are proposing rulemaking to implement and supplement the provisions of the Act relating to compensation committees and compensation advisers. Section 952 of the Act amends the Exchange Act by adding new Section 10C. Section 10C(a)(1) requires the Commission to adopt rules directing the exchanges to prohibit the listing of any equity security of an issuer, with certain exemptions, that is not in compliance with the independence requirements for members of the compensation committee. In accordance with the statute, the rules, once adopted, would require the exchanges to establish listing standards that require each member of a listed issuer's compensation committee to be a member of the board of directors and to be "independent." The term "independent" is not defined in Section 10C(a)(1). Instead, the section provides that "independent" is to be defined by the exchanges after taking into consideration relevant factors, including, but not limited to, the source of compensation of a director, including any consulting, advisory or other compensatory fee paid by the issuer to the director, and whether the director is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer.

In addition to the independence requirements set forth in Section 10C(a), Section 10C(f) requires the Commission to adopt rules directing the exchanges to prohibit the listing of any security of an issuer that is not in compliance with the following requirements relating to compensation committees and compensation advisers, as set forth in paragraphs (b) through (e) of Section 10C:

- Each compensation committee must have the authority, in its sole discretion, to retain or obtain the advice of compensation consultants, independent legal counsel and other advisers (collectively, "compensation advisers");[120]
- Before selecting any compensation adviser, the compensation committee must take into consideration specific factors identified by the Commission that affect the independence of compensation advisers;[121]

[120] Exchange Act Sections 10C(c)(1)(A) and 10C(d)(1) [15 U.S.C. 78j-3(c)(1)(A) and (d)(1)].

- The compensation committee must be directly responsible for the appointment, compensation and oversight of the work of any compensation adviser;[122] and
- Each listed issuer must provide appropriate funding for the payment of reasonable compensation, as determined by the compensation committee, to compensation advisers.[123]

Finally, Section 10C(c)(2) requires each listed issuer to disclose in any proxy or consent solicitation material for an annual meeting of shareholders (or a special meeting in lieu of the annual meeting), in accordance with Commission regulations, whether the issuer's compensation committee retained or obtained the advice of a compensation consultant; whether the work of the compensation consultant has raised any conflict of interest; and, if so, the nature of the conflict and how the conflict is being addressed.

Under Section 10C, our rules must permit the exchanges to exempt particular categories of issuers from the requirements of Section 10C and particular relationships from the compensation committee independence requirements of Section 10C(a). Our rules must also provide for appropriate procedures for an issuer to have a reasonable opportunity to cure any defects that might otherwise result in the delisting of the issuer's securities.

We are proposing new Exchange Act Rule 10C-1 to implement the compensation committee listing requirements of Sections 10C(a)-(g) of the Exchange Act. Proposed Rule 10C-1 closely tracks the statutory requirements of Section 10C. To implement Section 10C(c)(2) of the Exchange Act, we are proposing rule amendments to Regulation S-K to require disclosure, in any proxy or information statement relating to an annual meeting of shareholders at which

[121] Exchange Act Section 10C(b) [15 U.S.C. 78j-3(b)].

[122] Exchange Act Sections 10C(c)(1)(B) and 10C(d)(2) [15 U.S.C. 78j-3(c)(1)(B) and (d)(2)].

[123] Exchange Act Section 10C(e) [15 U.S.C. 78j-3(e)].

directors are to be elected (or special meeting in lieu of the annual meeting), of whether the issuer's compensation committee retained or obtained the advice of a compensation consultant; whether the work of the compensation consultant has raised any conflict of interest; and, if so, the nature of the conflict and how the conflict is being addressed. In connection with these amendments, we also propose to revise the current disclosure requirements relating to the retention of compensation consultants by providing a uniform trigger for when compensation consultant disclosures will be required. In addition, our proposed amendments would eliminate the existing exception from the requirement to identify compensation consultants and describe their engagements for those cases in which a consultant's role is limited to consulting on a broad-based plan or providing information that either is not customized for a particular registrant or that is customized based on parameters that are not developed by the compensation consultant, and about which the compensation consultant does not provide advice.

The Commission is sensitive to the costs and benefits imposed by the proposed rule and rule amendments. The discussion below focuses on the costs and benefits of the proposals made by the Commission to implement the Act within its permitted discretion, rather than the costs and benefits of the Act itself.

B. Benefits

The proposed rulemaking is intended to implement and supplement the requirements of Section 10C of the Exchange Act as set forth in Section 952 of the Act.

<u>Required Listing Standards</u>

Under proposed Rule 10C-1, the exchanges would be directed to adopt listing standards that would apply to any committee of the board that oversees executive compensation, whether or not such committee performs other functions or is formally designated as a "compensation committee." We believe this aspect of the rule proposal may help achieve the objectives of the Act by providing clarity and reducing any uncertainty about the application of Section 10C. Moreover, this may benefit investors because it would limit the ability of listed issuers to circumvent the compensation committee independence requirements under Section 10C by delegating oversight of executive compensation to a board committee that is not formally designated as the "compensation committee," but performs that function.

As directed by Section 10C, proposed Rule 10C-1 directs the exchanges to develop a definition of independence applicable to compensation committee members after considering the relevant factors set forth in Exchange Act Section 10C(a)(3). We do not propose to specify any additional factors that the exchanges must consider in determining independence requirements for compensation committee members. We believe that permitting exchanges greater latitude in crafting the required independence standards, subject to Commission review pursuant to Section 19(b) of the Exchange Act, may result in more efficient and effective determinations as to what types of relationships should preclude a finding of independence with respect to membership on a board committee that oversees executive compensation. Because issuers frequently consult the exchanges regarding independence determinations, the exchanges may be in the best position to identify the types of common relationships that are likely to compromise the ability of an issuer's compensation committee to make impartial determinations on executive compensation.

<u>Disclosure Amendments</u>

Our proposed amendments to Item 407(e)(3) of Regulation S-K would require the specific disclosures mandated by Section 10C(c)(2). While no other disclosures are proposed to be required, our proposed amendments would extend the disclosure requirement of Section 10C(c)(2) to issuers, whether listed or not, that file proxy or information statements relating to an election of directors. Although controlled companies are exempt from the requirements of Section 10C, we propose to extend the disclosure requirements of Section 10C(c)(2) to controlled companies in order to have uniform compensation consultant disclosure requirements for all issuers subject to our proxy rules. Under the proposed amendments, in addition to the disclosure currently required by Item 407(e)(3), issuers would be required to disclose whether the compensation committee has retained or obtained the advice of a compensation consultant, whether the work of the compensation consultant has raised any conflict of interest, and, if so, the nature of the conflict and how the conflict is being addressed.

We believe that requiring these disclosures of issuers subject to the proxy rules will benefit investors by providing them with easily understandable and uniform disclosure regarding compensation consultant conflicts of interest. Under our existing disclosure rules, these issuers must already discuss the selection of compensation consultants and disclose the nature and scope of their assignment, including any material instructions or directions governing their performance under the engagement. We believe the proposed amendment would complement these existing disclosure requirements by increasing the transparency of issuers' policies regarding compensation consultant conflicts of interest. To the extent that the relationships between an issuer and a compensation consultant are more transparent under the proposed amendments, investors should benefit through their ability to better monitor the process of recommending and determining executive and director pay. The increased disclosure should improve the ability of investors to monitor performance of directors responsible for overseeing compensation consultants, thus enabling them to make more informed voting and investment decisions.

We also propose to harmonize current Item 407(e)(3)(iii)'s disclosure triggers with the requirements of Section 10C(c)(2). Our goal in proposing uniform disclosure triggers is to prevent the adoption of potentially duplicative or overlapping disclosure requirements; we also believe that providing a uniform standard for when these disclosures will be required will benefit issuers by allowing them to streamline their procedures for ensuring proper disclosure compliance.

The proposed amendments also include an instruction that provides guidance to issuers as to whether the compensation committee has "obtained the advice" of a compensation consultant. This instruction should benefit issuers by providing clarity and reducing any uncertainty about whether disclosure under the new rules is required. In addition, we propose to include an instruction that identifies the factors set forth in proposed Rule 10C-1(b)(4)(i) through (v) as among the factors to be considered in determining whether there is a conflict of interest that may need to be disclosed in response to our proposed amendments to Item 407(e)(3)(iii). Although only listed issuers will be required to consider the five independence factors before selecting a compensation consultant, we believe that identifying these five factors as factors that should be considered in determining whether conflict of interest disclosure is required will aid all Exchange Act registrants subject to the proxy rules in complying with their proxy disclosure obligations.

C. Costs

Required Listing Standards

Under our proposed rules, exchanges would be required to adopt independence requirements that apply to members of listed issuer compensation committees or committees performing equivalent functions, but not to directors who oversee executive compensation matters in the absence of such committees. Some exchange listing standards currently require issuers to form compensation or equivalent committees; others require independent directors to oversee specified compensation matters but do not require the formation of a compensation or equivalent committee. Exchanges that do not require the formation of a compensation or equivalent committee could, on their own initiative, determine to apply the same independence standards to directors who oversee compensation matters in the absence of a compensation committee as they do to formally organized compensation committees. In the event they do not, however, issuers could seek to list on such exchanges in order to avoid having to comply with the compensation committee independence standards that would apply at the exchanges that require the formation of a compensation or equivalent committee. Further, to the extent exchanges compete for listings, they may have an incentive to propose standards that issuers may find less onerous. This could result in costs to exchanges to the extent they lose issuer listings, as well as costs to issuers to the extent they choose to alter their existing committee structure to avoid having to comply with the new standards.

Our decision not to exempt additional categories of issuers, beyond those specified in Section 10C(a)(1), from the independence requirements of our proposed rule and instead to rely on the various exchanges to propose additional exemptions for appropriate categories of issuers, may also result in certain direct or indirect costs. For example, the exchanges will bear the direct cost of evaluating whether additional exemptions would be appropriate and including such exemptions in the rule filings that they are required to make in order to comply with our proposed rule.

Disclosure Amendments

As noted above, our proposal implements the requirements of Section 10C(c)(2). In addition, although not required by Section 10C(c)(2), we propose to require all issuers subject to our proxy rules, rather than only listed issuers, to provide the disclosures called for by Section 10C(c)(2). We also propose to combine and streamline the new disclosure requirements with the existing compensation consultant disclosure requirements. Specifically, we propose to provide a uniform trigger for when compensation consultant disclosures will be required and eliminate the existing exception from the requirement to identify compensation consultants and describe their engagements for those cases in which a consultant's role is limited to consulting on a broad-based plan or providing non-customized benchmark compensation information.

As a result, controlled companies and non-listed issuers will incur costs in disclosing all compensation consultant engagements and in determining and disclosing whether the work of any compensation consultant has raised any conflict of interest, the nature of the conflict, and how the conflict is being addressed. These costs, which would not be required to be incurred by Section 10C(c)(2), may be mitigated to an extent because our existing rules already require issuers subject to our proxy rules to disclose, with limited exceptions, any role of compensation consultants in determining or recommending the amount or form of executive and director compensation. As a result, these issuers will already have developed procedures for collecting and analyzing information about the use of compensation consultants.

For purposes of the PRA, we estimate the aggregate annual cost of the proposed compensation consultant and related conflicts of interest disclosure to be approximately 23,940 hours of company personnel time and approximately $3,192,000 for the services of outside professionals. However, this amount includes the costs associated with the disclosure requirements of Section 10C(c)(2) of the Exchange Act, as well as our proposed extension of the disclosure requirement to controlled companies and non-listed issuers and the revisions proposed for the purpose of integrating the new disclosure requirements with existing Item 407(e)(3). As a result, a portion of the reporting costs are attributable to the requirements of the Act rather than to our proposed amendments to Item 407.

We have not proposed that compensation committees of non-listed issuers be required to consider the independence of compensation consultants or other compensation advisers before they are selected; nonetheless, in light of our proposal that issuers subject to our proxy rules will be required to identify and disclose how they manage any conflicts of interest raised by the work of compensation consultants that serve as advisers to the compensation committee, non-listed issuers may incur additional costs to develop more formalized selection processes than they otherwise would have absent such a disclosure requirement. For example, to prepare for the disclosure requirement, at the time any compensation consultant is selected, compensation committees of non-listed issuers may devote additional time and resources to analyzing and assessing the independence of the compensation consultant and addressing and resolving potential conflicts of interest. Although our proposed disclosure requirement will not preclude compensation committees from selecting the compensation consultant of their choosing, such committees may elect to engage new, alternative or additional compensation advisers after considering what disclosure might be required under our proposed rules. Such decisions could result in additional costs to issuers, including costs related to termination of existing services and search and engagement costs to retain new advisers. In addition, costs may increase if an issuer decides to engage multiple compensation consultants for services that had previously been provided by a single consultant.

As a mitigating factor, our proposed rules would require issuers to provide narrative disclosure regarding the management of conflicts of interest. To the extent a non-listed issuer's compensation committee determines to retain a compensation consultant, despite potential conflicts of interest, this provision provides the issuer a means to communicate to investors both the reasons why the committee believes that retaining the consultant and managing the potential conflict of interest is the best approach and the methods employed by the issuer to manage or address the potential conflict.

D. Request for Comment

We request data to quantify the costs and the value of the benefits described above. We seek estimates of these costs and benefits, as well as any costs and benefits not already defined, that may result from the adoption of these proposed amendments. We also request qualitative feedback on the nature of the benefits and costs described above and any benefits and costs we may have overlooked.

V. CONSIDERATION OF IMPACT ON THE ECONOMY, BURDEN ON COMPETITION AND PROMOTION OF EFFICIENCY, COMPETITION AND CAPITAL FORMATION

Section 23(a)(2) of the Exchange Act requires us, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition.[124] In addition, Section 23(a)(2) prohibits us from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

Section 2(b) of the Securities Act[125] and Section 3(f) of the Exchange Act[126] require us, when engaging in rulemaking where we are required to consider or determine whether an action

[124] 15 U.S.C. 78w(a)(2).

[125] 15 U.S.C. 77b(b).

[126] 15 U.S.C. 78c(f).

is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

Our proposed rule and rule amendments would implement the requirements of Section 952 of the Act, which added Section 10C to the Exchange Act. Among other provisions, Section 10C requires us to direct the exchanges to prohibit the listing of any equity security of an issuer that is not in compliance with Section 10C's compensation committee and compensation adviser requirements. It is possible that some listed issuers might find the proposed requirements too onerous and seek to list on foreign exchanges or other markets to avoid compliance. This could cause U.S. exchanges to lose trading volume. We do not believe our proposed rules are likely to have this effect, as issuers listed on U.S. exchanges must, for the most part, already provide for executive compensation oversight by independent directors.[127] It is also possible that, in competing for listings, the exchanges could adopt different definitions of independence for compensation committee members, which could affect an issuer's decision about where to list its securities.

Section 10C also requires disclosure from listed issuers, other than controlled companies. as to their use and oversight of compensation consultants. We propose to require companies subject to our proxy rules, including controlled companies, to provide this disclosure, whether listed or not. We believe this expansion of the statutory disclosure requirement will promote uniform disclosure on these topics among reporting companies and may allow investors to better understand the process by which compensation committees select compensation consultants and manage conflicts of interest.

Our proposals may promote efficiency and competitiveness of the U.S. capital markets by increasing the transparency of executive compensation decision-making processes and by

[127] See, e.g., NYSE Listed Company Manual Section 303A.05(a) and Nasdaq Rule 5605(d).

improving the ability of investors to make informed voting and investment decisions, which may encourage more efficient capital formation. The proposals also may affect competition among compensation consultants. By requiring disclosure of the existence and management of potential compensation consultant conflicts of interest, our proposed rules may lead compensation committees to engage in more thorough and deliberative analyses of adviser independence. If this results in the selection of compensation advisers that are more independent or impartial than might otherwise be chosen, this could in turn promote more efficient executive compensation determinations. The proposed disclosure also could incent consultants to compete on the basis of their policies that serve to minimize any potential conflicts of interest or, to the extent other consultants are available, lead compensation committees to avoid hiring consultants perceived as having a conflict of interest.

We request comment on whether the proposed amendments, if adopted, would promote efficiency, competition and capital formation or have an impact or burden on competition. Commentators are requested to provide empirical data and other factual support for their views, to the extent possible.

VI. SMALL BUSINESS REGULATORY ENFORCEMENT FAIRNESS ACT

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 (SBREFA),[128] we solicit data to determine whether the proposed rule amendments constitute a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in:

- An annual effect on the economy of $100 million or more (either in the form of an increase or a decrease);

[128] 5 U.S.C. 801 et seq.

- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effects on competition, investment or innovation.

Commentators should provide empirical data on (1) the potential annual effect on the economy; (2) any increase in costs or prices for consumers or individual industries; and (3) any potential effect on competition, investment or innovation.

VII. INITIAL REGULATORY FLEXIBILITY ACT ANALYSIS

This Initial Regulatory Flexibility Analysis (IRFA) has been prepared in accordance with the Regulatory Flexibility Act.[129] This IRFA involves proposals to direct the national securities exchanges and national securities associations to prohibit the listing of an equity security of an issuer that is not in compliance with several requirements relating to the issuer's compensation committee, and to revise the disclosure requirements of Regulation S-K Item 407 related to compensation consultants.

A. Reasons for, and Objectives of, the Proposed Action

We are proposing amendments to implement Section 10C of the Exchange Act as added by Section 952 of the Act. The proposals would direct the exchanges to prohibit the listing of equity securities of any issuer that does not comply with Section 10C's compensation committee and compensation adviser requirements. Our proposed amendments would also require issuers to provide certain disclosures regarding their use of compensation consultants and management of compensation consultant conflicts of interest.

B. Legal Basis

We are proposing the amendments pursuant to Sections 6, 7, 10, and 19(a) of the Securities Act; and Sections 10C, 12, 13, 14, 15(d), 23(a) and 36 of the Exchange Act.

[129] 5 U.S.C. 603.

C. Small Entities Subject to the Proposed Action

The proposals would affect exchanges that list equity securities and issuers subject to our proxy rules. The Regulatory Flexibility Act defines "small entity" to mean "small business," "small organization," or "small governmental jurisdiction."[130] The Commission's rules define "small business" and "small organization" for purposes of the Regulatory Flexibility Act for each of the types of entities regulated by the Commission. Exchange Act Rule 0-10(e) provides that the term "small business" or "small organization," when referring to an exchange, means any exchange that: (1) has been exempted from the reporting requirements of Exchange Act Rule 601;[131] and (2) is not affiliated with any person (other than a natural person) that is not a small business or small organization, as defined under Exchange Act Rule 0-10. No exchanges are small entities because none meet these criteria. Securities Act Rule 157[132] and Exchange Act Rule 0-10(a)[133] define a company, other than an investment company, to be a "small business" or "small organization" if it had total assets of $5 million or less on the last day of its most recent fiscal year. We estimate that there are approximately 1,207 registrants, other than registered investment companies, that may be considered small entities. The proposed amendments would affect small entities that have a class of securities that are registered under Section 12 of the Exchange Act. An investment company, including a business development company, is considered to be a "small business" if it, together with other investment companies in the same group of related investment companies, has net assets of $50 million or less as of the end of its

[130] 5 U.S.C. 601(6).

[131] 17 CFR 242.601.

[132] 17 CFR 230.157.

[133] 17 CFR 240.0-10(a).

most recent fiscal year.[134] We believe that the amendments to Item 407(e) of Regulation S-K would affect small entities that are business development companies that have a class of securities registered under Section 12 of the Exchange Act. We estimate that there are approximately 31 business development companies that may be considered small entities.

D. Reporting, Recordkeeping and other Compliance Requirements

Under the proposals, the exchanges will be directed to prohibit the listing of an equity security of an issuer that does not comply with Section 10C's compensation committee and compensation adviser requirements. These requirements relate to: the independence of compensation committee members; the authority of the compensation committee to engage compensation advisers; the compensation committee's responsibility for considering factors that affect the independence of compensation advisers prior to their selection; the compensation committee's responsibility for the appointment, compensation, and oversight of the work of compensation advisers; funding for advisers engaged by the compensation committee; and the opportunity to cure defects.

The proposals would also require additional disclosure about the use of compensation consultants and conflicts of interest. Large and small entities would be subject to the same disclosure requirements. The proposals would require small entities subject to the proxy rules to provide disclosure of whether:

- the compensation committee has retained or obtained the advice of a compensation consultant; and
- the work of a compensation consultant has raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed.

[134] 17 CFR 270.0-10(a).

The proposals will impose additional costs on small entities in order to comply with the new listing standards and to collect, record and report the disclosures that we propose to require. Our existing disclosure rules require small entities to disclose information regarding any compensation consultant that plays a role in determining or recommending the amount and form of executive and director compensation in proxy and information statements. The additional information concerning compensation consultants that would be required under the proposals should be readily available to these small entities. Also, we believe that many small entities do not use the services of a compensation consultant, which would significantly minimize the impact of the reporting and recordkeeping requirements under the proposals on small entities. In addition, we believe that the impact of the proposals on small entities will be lessened because most aspects of the proposals apply only to listed issuers, and the quantitative listing standards applicable to issuers listing securities on an exchange, such as market capitalization, minimum revenue, and shareholder equity requirements, will serve to limit the number of small entities that would be affected.

E. Duplicative, Overlapping or Conflicting Federal Rules

We believe the proposed amendments would not duplicate, overlap, or conflict with other federal rules.

F. Significant Alternatives

The Regulatory Flexibility Act directs us to consider alternatives that would accomplish our stated objectives, while minimizing any significant adverse impact on small entities. In connection with the proposed disclosure amendments, we considered the following alternatives:

- Clarifying, consolidating or simplifying compliance and reporting requirements under the rules for small entities;

- Using performance rather than design standards;
- Exempting small entities from all or part of the requirements; and
- Establishing different compliance or reporting requirements or timetables that take into account the resources available to small entities.

We believe that our proposed amendments would require clear and straightforward disclosure of the use of compensation consultants and the management of compensation consultant conflicts of interest. We believe that our proposed rules will promote consistent disclosure among all companies without creating a significant new burden for small entities.

The proposals attempt to clarify, consolidate and simplify the compliance and reporting requirements for all entities, including small entities, by including instructions to the amendments to clarify the circumstances under which disclosure is required. We have used a mix of design and performance standards in developing the proposed disclosure requirements. Based on our past experience, we believe the amendments will be more useful to investors if there are specific disclosure requirements; however, we have not proposed specific procedures or arrangements that an issuer must develop to comply with the proposed amendments. The additional disclosure requirements are intended to result in more comprehensive and clear disclosure.

Although we preliminarily believe that an exemption for small entities from coverage of the proposals would not be appropriate at this time, we seek comment on whether we should exempt small entities from any of the proposed disclosure requirements or scale the proposed amendments to reflect the characteristics of small entities and the needs of their investors. Further, as directed by Exchange Act Section 10C, our proposed rules would permit the exchanges to exempt particular categories of issuers from the requirements of Section 10C and particular relationships from the compensation committee membership requirements of Section 10C(a), taking into account the potential impact of the requirements on smaller reporting companies. To the extent exchanges adopt such exemptions for small entities, the compliance burden would be reduced.

At this time, we do not believe that different compliance methods or timetables for small entities would be appropriate. The proposals are intended to improve the accountability for and transparency of executive compensation determinations. The specific disclosure requirements in the proposals will promote consistent disclosure among all issuers, including small entities. Separate compliance requirements or timetables for small entities could interfere with achieving the goals of the statute and our proposals. Nevertheless, we solicit comment on whether different compliance requirements or timetables for small entities would be appropriate, and consistent with the purposes of Section 952 of the Dodd-Frank Act.

G. Solicitation of Comments

We encourage the submission of comments with respect to any aspect of this Initial Regulatory Flexibility Analysis. In particular, we request comments regarding:

- How the proposed amendments can achieve their objective while lowering the burden on small entities;
- The number of small entities that may be affected by the proposed amendments;
- Whether small entities should be exempt from the rules;
- The existence or nature of the potential impact of the proposed amendments on small entities discussed in the analysis; and
- How to quantify the impact of the proposed amendments.

Respondents are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed rule amendments are adopted, and will be placed in the same public file as comments on the proposed amendments themselves.

VIII. STATUTORY AUTHORITY AND TEXT OF THE PROPOSED AMENDMENTS

The amendments contained in this release are being proposed under the authority set forth in Sections 6, 7, 10, and 19(a) of the Securities Act and Sections 10C, 12, 13, 14, 15(d), 23(a), and 36 of the Exchange Act.

List of Subjects in 17 CFR Parts 229 and 240

Reporting and recordkeeping requirements, Securities.

TEXT OF THE PROPOSED AMENDMENTS

For the reasons set out in the preamble, the Commission proposes to amend title 17, chapter II, of the Code of Federal Regulations as follows:

PART 229 - STANDARD INSTRUCTIONS FOR FILING FORMS UNDER SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934 AND ENERGY POLICY AND CONSERVATION ACT OF 1975 - REGULATION S-K

1. The general authority citation for part 229 is revised and the sub-authorities are removed to read as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77iii, 77jjj, 77nnn, 77sss, 78c, 78i, 78j, 78j-3, 78l, 78m, 78n, 78n-1, 78o, 78u-5, 78w, 78ll, 78mm, 80a-8, 80a-9, 80a-20, 80a-29, 80a-30, 80a-31(c), 80a-37, 80a-38(a), 80a-39, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

2. Revise § 229.407(e)(3)(iii) to read as follows:

§ 229.407 (Item 407) Corporate governance.

* * * * *

(e) * * *

(3) * * *

(iii) Whether the compensation committee (or another board committee performing equivalent functions) retained or obtained the advice of a compensation consultant during the registrant's last completed fiscal year, identifying such consultants, stating whether such consultants were engaged directly by the compensation committee (or another board committee performing equivalent functions), describing the nature and scope of the consultant's assignment and the material elements of the instructions or directions given to the consultant with respect to the performance of the consultant's duties under the engagement, and discussing whether the work of the consultant has raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed:

(A) If the compensation committee (or another board committee performing equivalent functions) retained or obtained the advice of a compensation consultant and the consultant's services were not limited to consulting on any broad-based plan that does not discriminate in scope, terms, or operation, in favor of executive officers or directors of the registrant, and that is available generally to all salaried employees, or providing information that either is not customized for a particular registrant or that is customized based on parameters that are not developed by the compensation consultant, and about which the compensation consultant does not provide advice, and the compensation consultant or its affiliates also provided additional services to the registrant or its affiliates in an amount in excess of $120,000 during the registrant's last completed fiscal year, then disclose the aggregate fees for determining or recommending the amount or form of executive and director compensation and the aggregate fees for such additional services. Disclose whether the decision to engage the compensation consultant or its affiliates for these other services was made, or recommended, by management, and whether the compensation committee (or another board committee performing equivalent functions) or the board approved such other services of the compensation consultant or its affiliates.

(B) If the compensation committee (or another board committee performing equivalent functions) has not retained or obtained the advice of a compensation consultant, but management has retained or obtained the advice of a compensation consultant and the consultant's services were not limited to consulting on any broad-based plan that does not discriminate in scope, terms, or operation, in favor of executive officers or directors of the registrant, and that is available generally to all salaried employees, or providing information that either is not customized for a particular registrant or that is customized based on parameters that are not developed by the compensation consultant, and about which the compensation consultant does not provide advice, and such compensation consultant or its affiliates has provided additional services to the registrant in an amount in excess of $120,000 during the registrant's last completed fiscal year, then disclose the aggregate fees for determining or recommending the amount or form of executive and director compensation and the aggregate fees for any additional services provided by the compensation consultant or its affiliates.

Instruction 1 to Item 407(e)(3). For purposes of this paragraph, a compensation committee (or another board committee performing equivalent functions) or management has "obtained the advice" of a compensation consultant if such committee or management has requested or received advice from a compensation consultant, regardless of whether there is a formal engagement of the consultant or a client relationship between the compensation consultant and the compensation committee or management or any payment of fees to the consultant for its advice.

Instruction 2 to Item 407(e)(3). For purposes of this paragraph, the factors outlined in §240.10C-1(b)(4)(i) through (v) of this chapter are among the factors that should be considered in determining whether a conflict of interest exists.

* * * * *

PART 240 – GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

3. The general authority citation for Part 240 is revised to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78j-3, 78k, 78k-1,78l, 78m, 78n, 78n-1, 78o, 78o-4, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350, and 12 U.S.C. 5221(e)(3), unless otherwise noted.

4. Add an undesignated center heading following § 240.10A-3 to read as follows:

Requirements Under Section 10C

5. Add § 240.10C-1 to read as follows:

§ 240.10C-1 Listing standards relating to compensation committees.

(a) Pursuant to section 10C(a) of the Act (15 U.S.C. 78j-3(a)) and section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Pub. L. 111-203, 124 Stat. 1900):

(1) National Securities Exchanges. The rules of each national securities exchange registered pursuant to section 6 of the Act (15 U.S.C. 78f), to the extent such national securities

exchange lists equity securities, must, in accordance with the provisions of this section, prohibit the initial or continued listing of any equity security of an issuer that is not in compliance with the requirements of any portion of paragraph (b) or (c) of this section.

(2) National Securities Associations. The rules of each national securities association registered pursuant to section 15A of the Act (15 U.S.C. 78o-3), to the extent such national securities association lists equity securities in an automated inter-dealer quotation system, must, in accordance with the provisions of this section, prohibit the initial or continued listing in an automated inter-dealer quotation system of any equity security of an issuer that is not in compliance with the requirements of any portion of paragraph (b) or (c) of this section.

(3) Opportunity to Cure Defects. The rules required by paragraphs (a)(1) and (a)(2) of this section must provide for appropriate procedures for a listed issuer to have a reasonable opportunity to cure any defects that would be the basis for a prohibition under paragraph (a) of this section, before the imposition of such prohibition. Such rules may provide that if a member of a compensation committee ceases to be independent in accordance with the requirements of this section for reasons outside the member's reasonable control, that person, with notice by the issuer to the applicable national securities exchange or national securities association, may remain a compensation committee member of the listed issuer until the earlier of the next annual shareholders meeting of the listed issuer or one year from the occurrence of the event that caused the member to be no longer independent.

(4) Implementation. (i) Each national securities exchange and national securities association that lists equity securities must provide to the Commission, no later than 90 days after publication of this section in the Federal Register, proposed rules or rule amendments that comply with this section. Each submission must include, in addition to any other information

required under section 19(b) of the Act (15 U.S.C. 78s(b)) and the rules thereunder, a review of whether and how existing listing standards satisfy the requirements of this rule, a discussion of the consideration of factors relevant to compensation committee independence conducted by the national securities exchange or national securities association, and the definition of independence applicable to compensation committee members that the national securities exchange or national securities association proposes to adopt in light of such review.

(ii) Each national securities exchange and national securities association that lists equity securities must have rules or rule amendments that comply with this section approved by the Commission no later than one year after publication of this section in the Federal Register.

(b) Required Standards. The requirements of this section apply to the compensation committees of listed issuers. If a listed issuer has a committee of the board performing functions typically performed by a compensation committee, including oversight of executive compensation, then such committee, even if it is not designated as a compensation committee or performs other functions, shall be fully subject to the requirements of this section.

(1) Independence. (i) Each member of the compensation committee must be a member of the board of directors of the listed issuer, and must otherwise be independent.

(ii) Independence Requirements. In determining independence requirements for members of compensation committees, the national securities exchanges and national securities associations shall consider relevant factors, including, but not limited to:

(A) The source of compensation of a member of the board of directors of an issuer, including any consulting, advisory or other compensatory fee paid by the issuer to such member of the board of directors; and

(B) Whether a member of the board of directors of an issuer is affiliated with the issuer, a subsidiary of the issuer or an affiliate of a subsidiary of the issuer.

(iii) Exemptions from the Independence Requirements. (A) The listing of equity securities of the following categories of listed issuers are not subject to the requirements of paragraph (b)(1) of this section:

(1) Controlled companies;

(2) Limited partnerships;

(3) Companies in bankruptcy proceedings;

(4) Open-end management investment companies registered under the Investment Company Act of 1940; and

(5) Any foreign private issuer that discloses in its annual report the reasons that the foreign private issuer does not have an independent compensation committee.

(B) In addition to the issuer exemptions set forth in paragraph (b)(1)(iii)(A) of this section, a national securities exchange or a national securities association, pursuant to section 19(b) of the Act (15 U.S.C. 78s(b)) and the rules thereunder, may exempt from the requirements of paragraph (b)(1) of this section a particular relationship with respect to members of the compensation committee, as each national securities exchange or national securities association determines is appropriate, taking into consideration the size of an issuer and any other relevant factors.

(2) Authority to Engage Compensation Consultants, Independent Legal Counsel and Other Compensation Advisers. The compensation committee of a listed issuer, in its capacity as a committee of the board of directors, may, in its sole discretion, retain or obtain the advice of a compensation consultant, independent legal counsel or other adviser. The compensation

committee shall be directly responsible for the appointment, compensation and oversight of the work of any compensation consultant, independent legal counsel and other adviser to the compensation committee. Nothing in this paragraph shall be construed:

(i) To require the compensation committee to implement or act consistently with the advice or recommendations of the compensation consultant, independent legal counsel or other adviser to the compensation committee; or

(ii) To affect the ability or obligation of a compensation committee to exercise its own judgment in fulfillment of the duties of the compensation committee.

(3) Funding. Each listed issuer must provide for appropriate funding, as determined by the compensation committee, in its capacity as a committee of the board of directors, for payment of reasonable compensation to a compensation consultant, independent legal counsel or any other adviser to the compensation committee.

(4) Independence of Compensation Consultants and Other Advisers. The compensation committee of a listed issuer may select a compensation consultant, legal counsel, or other adviser to the compensation committee only after taking into consideration the following factors, as well as any other factors identified by the relevant national securities exchange or national securities association in its listing standards:

(i) The provision of other services to the issuer by the person that employs the compensation consultant, legal counsel or other adviser;

(ii) The amount of fees received from the issuer by the person that employs the compensation consultant, legal counsel or other adviser, as a percentage of the total revenue of the person that employs the compensation consultant, legal counsel, or other adviser;

(iii) The policies and procedures of the person that employs the compensation consultant, legal counsel or other adviser that are designed to prevent conflicts of interest;

(iv) Any business or personal relationship of the compensation consultant, legal counsel, or other adviser with a member of the compensation committee; and

(v) Any stock of the issuer owned by the compensation consultant, legal counsel or other adviser.

(5) General Exemptions. (i) The national securities exchanges and national securities associations, pursuant to section 19(b) of the Act (15 U.S.C. 78s(b)) and the rules thereunder, may exempt from the requirements of this section certain categories of issuers, as the national securities exchange or national securities association determines is appropriate, taking into consideration the potential impact of such requirements on smaller reporting issuers.

(ii) The requirements of this section shall not apply to any controlled company.

(iii) The listing of a security futures product cleared by a clearing agency that is registered pursuant to section 17A of the Act (15 U.S.C. 78q-1) or that is exempt from the registration requirements of section 17A(b)(7)(A) (15 U.S.C. 78q-1(b)(7)(A)) is not subject to the requirements of this section.

(iv) The listing of a standardized option, as defined in § 240.9b-1(a)(4), issued by a clearing agency that is registered pursuant to section 17A of the Act (15 U.S.C. 78q-1) is not subject to the requirements of this section.

(c) Definitions. Unless the context otherwise requires, all terms used in this section have the same meaning as in the Act. In addition, unless the context otherwise requires, the following definitions apply for purposes of this section:

(1) In the case of foreign private issuers with a two-tier board system, the term board of directors means the supervisory or non-management board.

(2) The term controlled company means an issuer:

(i) That is listed on a national securities exchange or by a national securities association; and

(ii) That holds an election for the board of directors of the issuer in which more than 50 percent of the voting power is held by an individual, a group or another issuer.

(3) The terms listed and listing refer to equity securities listed on a national securities exchange or listed in an automated inter-dealer quotation system of a national securities association or to issuers of such securities.

(4) The term open-end management investment company means an open-end company, as defined by Section 5(a)(1) of the Investment Company Act of 1940 (15 U.S.C. 80a-5(a)(1)), that is registered under that Act.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

March 30, 2011

DEPARTMENT OF THE TREASURY
Office of the Comptroller of the Currency
12 CFR Part 43
Docket No. OCC-2011-0002
RIN 1557-AD40

FEDERAL RESERVE SYSTEM
12 CFR Part 244
Docket No. 2011 - 1411
RIN 7100 AD 70

FEDERAL DEPOSIT INSURANCE CORPORATION
12 CFR Part 373
RIN 3064-AD74

U.S. SECURITIES AND EXCHANGE COMMISSION
17 CFR Part 246
Release No. 34-64148; File No. S7-14-11
RIN 3235-AK96

FEDERAL HOUSING FINANCE AGENCY
12 CFR Part 1234
RIN 2590-AA43

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Credit Risk Retention

AGENCIES: Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); U.S. Securities and Exchange Commission (Commission); Federal Housing Finance Agency (FHFA); and Department of Housing and Urban Development (HUD).

ACTION: Proposed rule.

SUMMARY: The OCC, Board, FDIC, Commission, FHFA, and HUD (the Agencies) are proposing rules to implement the credit risk retention requirements of section 15G of the Securities Exchange Act of 1934 (15. U.S.C. § 78o-11), as added by section 941 of

the Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 15G generally requires the securitizer of asset-backed securities to retain not less than five percent of the credit risk of the assets collateralizing the asset-backed securities. Section 15G includes a variety of exemptions from these requirements, including an exemption for asset-backed securities that are collateralized exclusively by residential mortgages that qualify as "qualified residential mortgages," as such term is defined by the Agencies by rule.

DATES: Comments must be received by June 10, 2011.

ADDRESSES: Interested parties are encouraged to submit written comments jointly to all of the Agencies. Commenters are encouraged to use the title "Credit Risk Retention" to facilitate the organization and distribution of comments among the Agencies. Commenters are also encouraged to identify the number of the specific request for comment to which they are responding.

Office of the Comptroller of the Currency: Because paper mail in the Washington, DC area and at the OCC is subject to delay, commenters are encouraged to submit comments by the Federal eRulemaking Portal or e-mail, if possible. Please use the title "Credit Risk Retention" to facilitate the organization and distribution of the comments. You may submit comments by any of the following methods:

- **Federal eRulemaking Portal – "Regulations.gov":** Go to http://www.regulations.gov, under the "More Search Options" tab click next to the "Advanced Docket Search" option where indicated, select "Comptroller of the Currency" from the agency drop-down menu, then click "Submit." In the "Docket ID" column, select "OCC-2010-0002" to submit or view public comments and to view supporting and related materials for this proposed rule. The "How to Use This Site" link on the Regulations.gov home page provides information on using Regulations.gov, including instructions for submitting or viewing public comments, viewing other supporting and related materials, and viewing the docket after the close of the comment period.

- **E-mail:** regs.comments@occ.treas.gov.
- **Mail:** Office of the Comptroller of the Currency, 250 E Street, SW., Mail Stop 2-3, Washington, DC 20219.
- **Fax:** (202) 874-5274.
- **Hand Delivery/Courier:** 250 E Street, SW., Mail Stop 2-3, Washington, DC 20219.

Instructions: You must include "OCC" as the agency name and "Docket Number OCC-2010-0002" in your comment. In general, OCC will enter all comments received into the docket and publish them on the Regulations.gov Web site without change, including any business or personal information that you provide such as name and address information, e-mail addresses, or phone numbers. Comments received, including attachments and other supporting materials, are part of the public record and subject to public disclosure. Do not enclose any information in your comment or supporting materials that you consider confidential or inappropriate for public disclosure.

You may review comments and other related materials that pertain to this proposed rulemaking by any of the following methods:

- **Viewing Comments Electronically:** Go to http://www.regulations.gov, under the "More Search Options" tab click next to the "Advanced Document Search" option where indicated, select "Comptroller of the Currency" from the agency drop-down menu, then click "Submit." In the "Docket ID" column, select "OCC-2011-0002" to view public comments for this rulemaking action.

- **Viewing Comments Personally:** You may personally inspect and photocopy comments at the OCC, 250 E Street, SW., Washington, DC. For security reasons, the OCC requires that visitors make an appointment to inspect comments. You may do so by calling (202) 874-4700. Upon arrival, visitors will be required to present valid government-issued photo identification and submit to security screening in order to inspect and photocopy comments.
- **Docket:** You may also view or request available background documents and project summaries using the methods described above.

Board of Governors of the Federal Reserve System:

You may submit comments, identified by Docket No. R-1411, by any of the following methods:

- **Agency Web Site**: http://www.federalreserve.gov. Follow the instructions for submitting comments at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm.
- **Federal eRulemaking Portal**: http://www.regulations.gov. Follow the instructions for submitting comments.
- **E-mail**: regs.comments@federalreserve.gov. Include the docket number in the subject line of the message.
- **Fax**: (202) 452-3819 or (202) 452-3102.

- **Mail**: Address to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW, Washington, DC 20551.

All public comments will be made available on the Board's web site at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm as submitted, unless modified for technical reasons. Accordingly, comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper in Room MP-500 of the Board's Martin Building (20th and C Streets, N.W.) between 9:00 a.m. and 5:00 p.m. on weekdays.

Federal Deposit Insurance Corporation: You may submit comments, identified by RIN number, by any of the following methods:

- **Agency Web Site:** http://www.FDIC.gov/regulations/laws/federal/notices.html. Follow instructions for submitting comments on the Agency Web Site.
- **E-mail:** Comments@FDIC.gov. Include the RIN number on the subject line of the message.
- **Mail:** Robert E. Feldman, Executive Secretary, Attention: Comments, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.
- **Hand Delivery**: Comments may be hand delivered to the guard station at the rear of the 550 17th Street Building (located on F Street) on business days between 7:00 a.m. and 5:00 p.m.

Instructions: All comments received must include the agency name and RIN for this rulemaking and will be posted without change to http://www.fdic.gov/regulations/laws/ federal/propose.html, including any personal information provided.

Securities and Exchange Commission: You may submit comments by the following method:

Electronic Comments

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-14-11 on the subject line; or
- Use the Federal eRulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090.
- All submissions should refer to File Number S7-14-11. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/proposed.shtml). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change;

we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

Federal Housing Finance Agency: You may submit your written comments on the proposed rulemaking, identified by RIN number 2590-AA43, by any of the following methods:

- **E-mail**: Comments to Alfred M. Pollard, General Counsel, may be sent by e-mail at RegComments@fhfa.gov. Please include "RIN 2590-AA43" in the subject line of the message.
- **Federal eRulemaking Portal: http://www.regulations.gov**. Follow the instructions for submitting comments. If you submit your comment to the Federal eRulemaking Portal, please also send it by e-mail to FHFA at RegComments@fhfa.gov to ensure timely receipt by the Agency. Please include ''RIN 2590–AA43'' in the subject line of the message.
- **U.S. Mail, United Parcel Service, Federal Express, or Other Mail Service:** The mailing address for comments is: Alfred M. Pollard, General Counsel, Attention: Comments/RIN 2590-AA43, Federal Housing Finance Agency, Fourth Floor, 1700 G Street, NW., Washington, DC 20552.
- **Hand Delivery/Courier**: The hand delivery address is: Alfred M. Pollard, General Counsel, Attention: Comments/RIN 2590-AA43, Federal Housing Finance Agency, Fourth Floor, 1700 G Street, NW., Washington, DC 20552. A hand-delivered package should be logged at the Guard Desk, First Floor, on business days between 9:00 a.m. and 5:00 p.m.

All comments received by the deadline will be posted for public inspection without change, including any personal information you provide, such as your name and address, on the FHFA website at http://www.fhfa.gov. Copies of all comments timely received will be available for public inspection and copying at the address above on government-business days between the hours of 10 a.m. and 3 p.m. To make an appointment to inspect comments please call the Office of General Counsel at (202) 414-6924.

Department of Housing and Urban Development: Interested persons are invited to submit comments regarding this rule to the Regulations Division, Office of General Counsel, Department of Housing and Urban Development, 451 7th Street, SW, Room 10276, Washington, DC 20410-0500. Communications must refer to the above docket number and title. There are two methods for submitting public comments. All submissions must refer to the above docket number and title.

- **Submission of Comments by Mail.** Comments may be submitted by mail to the Regulations Division, Office of General Counsel, Department of Housing and Urban Development, 451 7th Street, SW, Room 10276, Washington, DC 20410-0500.
- **Electronic Submission of Comments.** Interested persons may submit comments electronically through the Federal eRulemaking Portal at www.regulations.gov. HUD strongly encourages commenters to submit comments electronically. Electronic submission of comments allows the commenter maximum time to prepare and submit a comment, ensures timely receipt by HUD, and enables HUD to make them immediately available to the public. Comments submitted electronically through the www.regulations.gov

website can be viewed by other commenters and interested members of the public. Commenters should follow the instructions provided on that site to submit comments electronically.

- **Note**: To receive consideration as public comments, comments must be submitted through one of the two methods specified above. Again, all submissions must refer to the docket number and title of the rule.
- **No Facsimile Comments.** Facsimile (FAX) comments are not acceptable.
- **Public Inspection of Public Comments**. All properly submitted comments and communications submitted to HUD will be available for public inspection and copying between 8 a.m. and 5 p.m. weekdays at the above address. Due to security measures at the HUD Headquarters building, an appointment to review the public comments must be scheduled in advance by calling the Regulations Division at 202-708-3055 (this is not a toll-free number). Individuals with speech or hearing impairments may access this number via TTY by calling the Federal Information Relay Service at 800-877-8339. Copies of all comments submitted are available for inspection and downloading at www.regulations.gov.

FOR FURTHER INFORMATION CONTACT:

OCC: Chris Downey, Risk Specialist, Financial Markets Group, (202) 874-4660; Kevin Russell, Director, Retail Credit Risk, (202) 874-5170; Darrin Benhart, Director, Commercial Credit Risk, (202) 874-5670; or Jamey Basham, Assistant Director, or Carl Kaminski, Senior Attorney, Legislative and Regulatory Activities Division, (202) 874-

5090, Office of the Comptroller of the Currency, 250 E Street SW., Washington, DC 20219.

Board: Benjamin W. McDonough, Counsel, (202) 452-2036; April C. Snyder, Counsel, (202) 452-3099; Sebastian R. Astrada, Attorney, (202) 452-3594; or Flora H. Ahn, Attorney, (202) 452-2317, Legal Division; Thomas R. Boemio, Manager, (202) 452-2982; Donald N. Gabbai, Senior Supervisory Financial Analyst, (202) 452-3358; or Sviatlana A. Phelan, Financial Analyst, (202) 912-4306, Division of Banking Supervision and Regulation; Andreas Lehnert, Deputy Director, Office of Financial Stability Policy and Research, (202) 452-3325; or Brent Lattin, Counsel, (202) 452-3367, Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington , D.C. 20551.

FDIC: Beverlea S. Gardner, Special Assistant to the Chairman, (202) 898-3640; Mark L. Handzlik, Counsel, (202) 898-3990; Phillip E. Sloan, Counsel, (703) 562-6137; or Petrina R. Dawson, Counsel, (703) 562-2688, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

Commission: Jay Knight, Attorney-Advisor in the Office of Rulemaking, or Katherine Hsu, Chief of the Office of Structured Finance, Division of Corporation Finance, at (202) 551-3753, U.S. Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-3628.

FHFA: Patrick J. Lawler, Associate Director and Chief Economist, Patrick.Lawler@fhfa.gov, (202) 414-3746; Austin Kelly, Associate Director for Housing Finance Research, Austin.Kelly@fhfa.gov, (202) 343-1336; Phillip Millman, Principal Capital Markets Specialist, Phillip.Millman@fhfa.gov, (202) 343-1507; or Thomas E.

Joseph, Senior Attorney Advisor, Thomas.Joseph@fhfa.gov, (202) 414-3095; Federal Housing Finance Agency, Third Floor, 1700 G Street, NW., Washington, DC 20552. The telephone number for the Telecommunications Device for the Hearing Impaired is (800) 877-8339.

HUD: Robert C. Ryan, Deputy Assistant Secretary for Risk Management and Regulatory Affairs, Office of Housing, Department of Housing and Urban Development, 451 7th Street, SW, Room 9106, Washington, DC 20410; telephone number 202-402-5216 (this is not a toll-free number). Persons with hearing or speech impairments may access this number through TTY by calling the toll-free Federal Information Relay Service at 800-877-8339.

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I. Introduction

The Agencies are requesting comment on proposed rules (proposal or proposed rules) to implement the requirements of section 941(b) of the Dodd–Frank Wall Street Reform and Consumer Protection Act (the Act, or Dodd–Frank Act),[1] which is codified as new section 15G of the Securities Exchange Act of 1934 (the Exchange Act).[2] Section 15G of the Exchange Act, as added by section 941(b) of the Dodd-Frank Act, generally requires the Board, the FDIC, the OCC (collectively, referred to as the Federal banking agencies), the Commission, and, in the case of the securitization of any "residential

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[1] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[2] 15 U.S.C. § 78o-11

mortgage asset," together with HUD and FHFA, to jointly prescribe regulations that (i) require a securitizer to retain not less than five percent of the credit risk of any asset that the securitizer, through the issuance of an asset-backed security (ABS), transfers, sells, or conveys to a third party, and (ii) prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain under section 15G and the Agencies' implementing rules.[3]

Section 15G of the Exchange Act exempts certain types of securitization transactions from these risk retention requirements and authorizes the Agencies to exempt or establish a lower risk retention requirement for other types of securitization transactions. For example, section 15G specifically provides that a securitizer shall not be required to retain any part of the credit risk for an asset that is transferred, sold, or conveyed through the issuance of ABS by the securitizer, if all of the assets that collateralize the ABS are qualified residential mortgages (QRMs), as that term is jointly defined by the Agencies.[4] In addition, section 15G states that the Agencies must permit a securitizer to retain less than five percent of the credit risk of commercial mortgages, commercial loans, and automobile loans that are transferred, sold, or conveyed through the issuance of ABS by the securitizer if the loans meet underwriting standards established by the Federal banking agencies.[5]

As shown in tables A, B, C, and D below, the securitization markets are an important source of credit to U.S. households and businesses and state and local

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[3] See 15 U.S.C. §78o-11(b), (c)(1)(A) and (c)(1)(B)(ii).

[4] See 15 U.S.C. § 78o-11(c)(1)(C)(iii), (4)(A) and (B).

[5] See id. at § 78o-11(c)(1)(B)(ii) and (2).

governments.[6]

Table A - Total US Asset and Mortgage Backed Securitizations Issued per year, dollars in millions

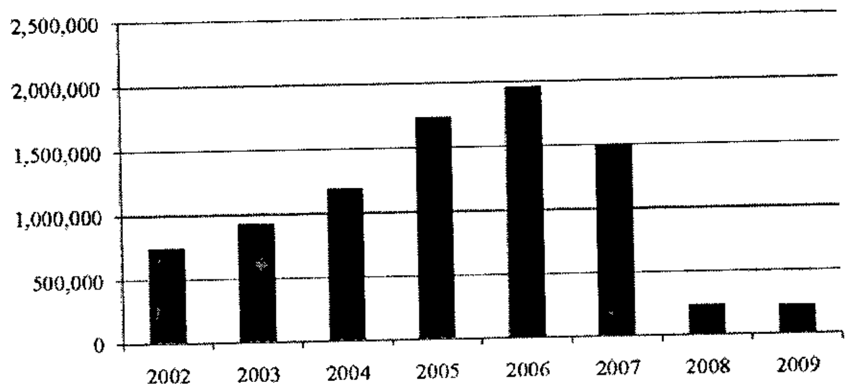
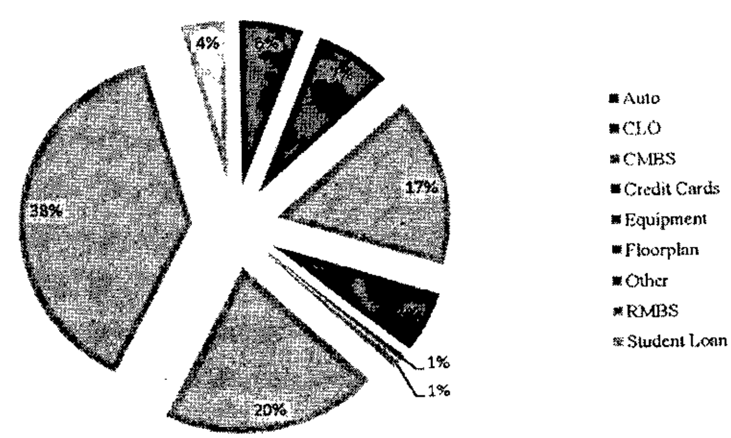


Table B - Percentage of Dollar Amount of All New Asset-Backed Issuances from 2005-2009



[6] Data are through September 2010. All data from Asset Backed Alert except: CMBS data from Commercial Mortgage Alert, CLO data from Securities Industry and Financial Markets Association. The tables do not include any data on securities issued or guaranteed by the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation.

Table C - Percentage of Dollar Amount of All New Asset-Backed Issuances from 2002-2009

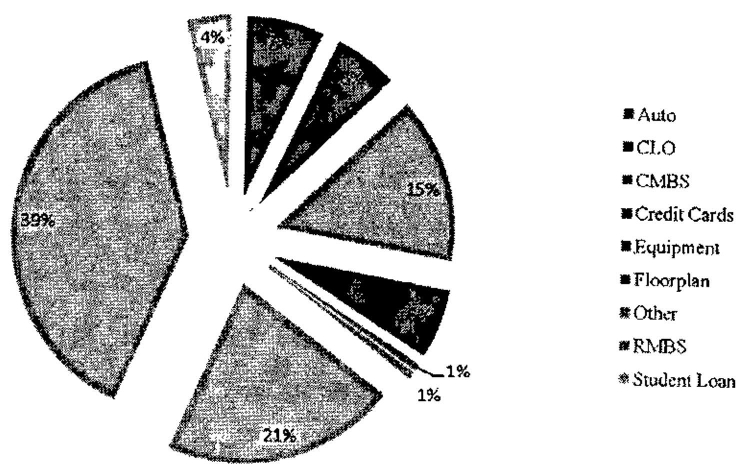


Table D - Total US Asset and Mortgage Backed Securitizations Issued per year (dollars in millions)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	Total 2002 3Q2010
Auto	95484	86350	72881	103717	82000	66773	35469	53944	43104	**639,724**
CLO	30388	22584	32192	69441	171906	138827	27489	2033		**494,860**
CMBS	89900	107354	136986	245883	305714	319863	33583	38750	27297	**1,305,329**
Credit Cards	73004	67385	51188	62916	72518	94470	61628	46581	6149	**535,839**
Equipment	7062	9022	6288	9030	8404	6066	3014	7240	5010	**61,137**
Floorplan	3000	6315	11848	12670	12173	6925	1000	4959	8619	**67,510**
Other	135384	196769	330161	444137	516175	165515	19872	10652	24936	**1,843,601**
RMBS	287916	396288	503911	724115	723257	641808	28612	48082	39830	**3,393,819**
Student Loan	25367	40067	45759	62212	65745	58122	28199	20839	13899	**360,210**
Total	**747,506**	**932,134**	**1,191,216**	**1,734,122**	**1,957,891**	**1,498,370**	**238,868**	**233,079**	**168,843**	

Note: 2010 Data are through the month of September.

When properly structured, securitization provides economic benefits that lower the cost of credit to households and businesses.[7] However, when incentives are not properly aligned and there is a lack of discipline in the origination process, securitization can result in harm to investors, consumers, financial institutions, and the financial system. During the financial crisis, securitization displayed significant vulnerabilities to informational and incentive problems among various parties involved in the process.[8]

For example, as noted in the legislative history of section 15G, under the "originate to distribute" model, loans were made expressly to be sold into securitization pools, with lenders often not expecting to bear the credit risk of borrower default.[9] In addition, participants in the securitization chain may be able to affect the value of the ABS in opaque ways, both before and after the sale of the securities, particularly if those assets are resecuritized into complex instruments such as collateralized debt obligations

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[7] Securitization may reduce the cost of funding, which is accomplished through several different mechanisms. For example, firms that specialize in originating new loans and that have difficulty funding existing loans may use securitization to access more liquid capital markets for funding. In addition, securitization can create opportunities for more efficient management of the asset–liability duration mismatch generally associated with the funding of long-term loans, for example, with short-term bank deposits. Securitization also allows the structuring of securities with differing maturity and credit risk profiles that may appeal to a broad range of investors from a single pool of assets. Moreover, securitization that involves the transfer of credit risk allows financial institutions that primarily originate loans to particular classes of borrowers, or in particular geographic areas, to limit concentrated exposure to these idiosyncratic risks on their balance sheets. See generally Report to the Congress on Risk Retention, Board of Governors of the Federal Reserve System, at 8 (October 2010), available at http://federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf (Board Report).

[8] See Board Report at 8-9.

[9] See S. Rep. No. 111-176, at 128 (2010).

(CDOs) and CDOs-squared.[10] Moreover, some lenders using an "originate-to-distribute" business model loosened their underwriting standards knowing that the loans could be sold through a securitization and retained little or no continuing exposure to the quality of those assets.[11]

The risk retention requirements added by section 15G are intended to help address problems in the securitization markets by requiring that securitizers, as a general matter, retain an economic interest in the credit risk of the assets they securitize. As indicated in the legislative history of section 15G, "When securitizers retain a material amount of risk, they have 'skin in the game,' aligning their economic interest with those of investors in asset-backed securities."[12] By requiring that the securitizer retain a portion of the credit risk of the assets being securitized, section 15G provides securitizers an incentive to monitor and ensure the quality of the assets underlying a securitization transaction, and thereby helps align the interests of the securitizer with the interests of investors. Additionally, in circumstances where the assets collateralizing the ABS meet underwriting and other standards that should ensure the assets pose low credit risk, the statute provides or permits an exemption.[13]

The credit risk retention requirements of section 15G are an important part of the legislative and regulatory efforts to address weaknesses and failures in the securitization process and the securitization markets. Section 15G complements other parts of the Dodd-Frank Act intended to improve the securitization markets. These include, among

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[10] See id.

[11] See id.

[12] See id. at 129.

[13] See 15 U.S.C. § 78o-11(c)(1)(B)(ii),(e)(1)-(2).

others, provisions that strengthen the regulation and supervision of nationally recognized statistical rating agencies (NRSROs) and improve the transparency of credit ratings;[14] provide for issuers of registered ABS offerings to perform a review of the assets underlying the ABS and disclose the nature of the review;[15] and require issuers of ABS to disclose the history of the repurchase requests they received and repurchases they made related to their outstanding ABS.[16]

In developing the proposed rules, the Agencies have taken into account the diversity of assets that are securitized, the structures historically used in securitizations, and the manner in which securitizers may have retained exposure to the credit risk of the assets they securitize.[17] As described in detail below, the proposed rules provide several options securitizers may choose from in meeting the risk retention requirements of section 15G, including, but not limited to, retention of a five percent "vertical" slice of each class of interests issued in the securitization or retention of a five percent "horizontal" first-loss interest in the securitization, as well as other risk retention options that take into account the manners in which risk retention often has occurred in credit card receivable and automobile loan and lease securitizations and in connection with the issuance of asset-backed commercial paper. The proposed rules also include a special "premium capture" mechanism designed to prevent a securitizer from structuring an ABS

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14 See, e.g., sections 932, 935, 936, 938, and 943 of the Dodd-Frank Act.

15 See section 945 of the Dodd-Frank Act.

16 See section 943 of the Dodd-Frank Act.

17 Both the language and legislative history of section 15G indicate that Congress expected the agencies to be mindful of the heterogeneity of securitization markets. See, e.g., 15 U.S.C. § 78o-11(c)(1)(E),(c)(2),(e); S. Rep. No. 111-76, at 130 (2010) ("The Committee believes that implementation of risk retention obligations should recognize the differences in securitization practices for various asset classes.")

transaction in a manner that would allow the securitizer to effectively negate or reduce its retained economic exposure to the securitized assets by immediately monetizing the excess spread created by the securitization transaction.[18] In designing these options and the proposed rules in general, the Agencies have sought to ensure that the amount of credit risk retained is meaningful—consistent with the purposes of section 15G—while reducing the potential for the proposed rules to negatively affect the availability and costs of credit to consumers and businesses.

As required by section 15G, the proposed rules provide a complete exemption from the risk retention requirements for ABS that are collateralized solely by QRMs and establish the terms and conditions under which a residential mortgage would qualify as a QRM. In developing the proposed definition of a QRM, the Agencies carefully considered the terms and purposes of section 15G, public input, and the potential impact of a broad or narrow definition of QRMs on the housing and housing finance markets.

As discussed in greater detail in Part V of this Supplementary Information, the proposed rules would generally prohibit QRMs from having product features that contributed significantly to the high levels of delinquencies and foreclosures since 2007—such as terms permitting negative amortization, interest-only payments, or significant interest rate increases—and also would establish underwriting standards designed to ensure that QRMs are of very high credit quality consistent with their exemption from risk retention requirements. These underwriting standards include,

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[18] "Excess spread" is the difference between the gross yield on the pool of securitized assets less the cost of financing those assets (weighted average coupon paid on the investor certificates), charge-offs, servicing costs, and any other trust expenses (such as insurance premiums, if any).

among other things, maximum front-end and back-end debt-to-income ratios of 28 percent and 36 percent, respectively;[19] a maximum loan-to-value (LTV) ratio of 80 percent in the case of a purchase transaction (with a lesser combined LTV permitted for refinance transactions); a 20 percent down payment requirement in the case of a purchase transaction; and credit history restrictions.

The proposed rules also would not require a securitizer to retain any portion of the credit risk associated with a securitization transaction if the ABS issued are exclusively collateralized by commercial loans, commercial mortgages, or automobile loans that meet underwriting standards included in the proposed rules for the individual asset class. As for QRMs, these underwriting standards are designed to be robust and ensure that the loans backing the ABS are of very low credit risk. In this Supplementary Information, the Agencies refer to these assets (including QRMs) as "qualified assets."

The Agencies recognize that many prudently underwritten residential and mortgage loans, commercial loans, and automobile loans may not satisfy all the underwriting and other criteria in the proposed rules for qualified assets. Securitizers of ABS backed by such prudently underwritten loans would, as a general matter, be required to retain credit risk under the rule. However, as noted above, the Agencies have sought to structure the proposed risk retention requirements in a flexible manner that would allow the securitization markets for non-qualified assets to function in a manner that both

[19] A front-end debt-to-income ratio measures how much of the borrower's gross (pretax) monthly income is represented by the borrower's required payment on the first-lien mortgage, including real estate taxes and insurance. A back-end debt-to-income ratio measures how much of a borrower's gross (pretax) monthly income would go toward monthly mortgage and nonmortgage debt service obligations.

facilitates the flow of credit to consumers and businesses on economically viable terms and is consistent with the protection of investors.

Section 15G allocates the authority for writing rules to implement its provisions among the Agencies in various ways. As a general matter, the Agencies collectively are responsible for adopting joint rules to implement the risk retention requirements of section 15G for securitizations that are backed by residential mortgage assets and for defining what constitutes a QRM for purposes of the exemption for QRM-backed ABS.[20] The Federal banking agencies and the Commission, however, are responsible for adopting joint rules that implement section 15G for securitizations backed by all other types of assets,[21] and also are the agencies authorized to adopt rules in several specific areas under section 15G.[22] In addition, the Federal banking agencies are responsible for establishing, by rule, the underwriting standards for non-QRM residential mortgages, commercial mortgages, commercial loans and automobile loans that would qualify ABS backed by these types of loans for a less than five percent risk retention requirement.[23]

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[20] See id. at § 78o-11(b)(2), (e)(4)(A) and (B).

[21] See id. at § 78o-11(b)(1).

[22] See, e.g. id. at §§ 78o-11(b)(1)(E) (relating to the risk retention requirements for ABS collateralized by commercial mortgages); (b)(1)(G)(ii) (relating to additional exemptions for assets issued or guaranteed by the United States or an agency of the United States); (d) (relating to the allocation of risk retention obligations between a securitizer and an originator); and (e)(1) (relating to additional exemptions, exceptions or adjustments for classes of institutions or assets).

[23] See id. at § 78o-11(b)(2)(B). Therefore, pursuant to section 15G, only the Federal banking agencies are proposing the underwriting definitions in § __.16 (except the asset class definitions of automobile loan, commercial loan, and commercial real estate loan, which are being proposed by the Federal banking agencies and the Commission), and the underwriting standards in §§__.18(b)(1) – (6), __.19(b)(1) – (9), and __.20(b)(1) – (8) of the proposed rules. At the final rule stage, FHFA proposes to adopt only those provisions of the common rules that address the types of asset securitization transactions in which its

Accordingly, when used in this proposal, the term "Agencies" shall be deemed to refer to the appropriate Agencies that have rulewriting authority with respect to the asset class, securitization transaction, or other matter discussed. The Secretary of the Treasury, as Chairperson of the Financial Stability Oversight Council, coordinated the development of these joint proposed rules in accordance with the requirements of section 15G.[24]

For ease of reference, the proposed rules of the Agencies are referenced using a common designation of §__.1 to §__.23 (excluding the title and part designations for each Agency). With the exception of HUD, each Agency will codify the rules, when adopted in final form, within each of their respective titles of the Code of Federal Regulations.[25] Section __.1 of each Agency's proposed rules identifies the entities or transactions that would be subject to such Agency's rules.[26]

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regulated entities could be authorized to engage under existing law. The remaining provisions, such as those addressing underwriting standards for non-residential commercial loans and auto loans, would be designated as [reserved], and the provisions adopted would be numbered and otherwise designated so as to correspond to the equivalent provisions appearing in the regulations of the other Agencies.

[24] See id. at § 78o-11(h).

[25] Specifically, the agencies propose to codify the rules as follows: 12 CFR part 43 (OCC); 12 CFR part 244 (Regulation RR) (Board); 12 CFR part 373 (FDIC); 17 CFR part 246 (Commission); 12 CFR part 1234 (FHFA). As required by section 15G, HUD has jointly prescribed the proposed rules for a securitization that is backed by any residential mortgage asset and for purposes of defining a qualified residential mortgage. Because the proposed rules would exempt the programs and entities under HUD's jurisdiction from the requirements of the proposed rules, HUD does not propose to codify the rules into its title of the CFR at the time the rules are adopted in final form.

[26] The joint proposed rules being adopted by the Agencies would apply to all sponsors that fall within the scope of 15G, including state and federal savings associations and savings and loan holding companies. These entities are currently regulated and supervised by the Office of Thrift Supervision (OTS), which is not among the Federal banking agencies with rulemaking authority under section 15G. Authority of the OTS under the Home Owners' Loan Act (12 U.S.C. 1461 et seq.) with respect to such entities will transfer from the OTS to the Board, FDIC, and OCC on the transfer date provided in section 311 of the Dodd-Frank Act. This transfer will take place well before the effective

In light of the joint nature of the Agencies' rulewriting authority under section 15G, the appropriate Agencies will jointly approve any written interpretations, written responses to requests for no-action letters and legal opinions, or other written interpretive guidance concerning the scope or terms of section 15G and the final rules issued thereunder that are intended to be relied on by the public generally.[27] Similarly, the appropriate Agencies will jointly approve any exemptions, exceptions, or adjustments to the final rules.[28] For these purposes, the phrase "appropriate Agencies" refers to the Agencies with rulewriting authority for the asset class, securitization transaction, or other matter addressed by the interpretation, guidance, exemption, exceptions, or adjustments. The Agencies expect to coordinate with each other to facilitate the processing, review and action on requests for such written interpretations or guidance, or additional exemptions, exceptions or adjustments.

II. General Definitions and Scope

Section __.2 of the proposed rules defines terms used throughout the proposed rules. Certain of these definitions are discussed in this part of the Supplementary Information. Other terms are discussed together with the section of the proposed rules where they are used. For example, certain definitions that relate solely to the exemptions for securitizations based on QRMs and certain qualifying commercial, commercial real

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date of the Federal banking agencies' final rules under section 15G. Accordingly, the final rules issued by the appropriate Federal banking agency would include the relevant set of these entities in the agency's Purpose, Authority, and Scope section (§ __.1).

[27] These items would not include staff comment letters and informal written guidance provided to specific institutions or matters raised in a report of examination or inspection of a supervised institution, which are not intended to be relied on by the public generally.

[28] See 15 U.S.C. §§ 78o-11(c)(1)(G)(i) and (e)(1); proposed rules at § __.22.

estate, and automobile loans, are contained in, and are discussed in the context of, those sections (see subpart C of the proposed rules).

A. Asset-Backed Securities, Securitization Transaction and ABS Interests

The proposed risk retention rules would apply to securitizers in securitizations that involve the issuance of "asset-backed securities" as defined in section 3(a)(77) of the Exchange Act, which also was added to the Exchange Act by section 941 of the Dodd-Frank Act.[29] Section 3(a)(77) of the Exchange Act generally defines an "asset-backed security" to mean "a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, lease, mortgage, or other secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset."[30] The proposed rules incorporate by reference this definition of asset-backed security from the Exchange Act.[31] Consistent with this definition, the proposed rules also define the term "asset" to mean a self-liquidating financial asset, including loans, leases, or other receivables.[32] The proposal

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[29] See section 941(a) of the Dodd-Frank Act.

[30] See 15 U.S.C. § 78c(a)(77). The term also (i) includes any other security that the Commission, by rule, determines to be an asset-backed security for purposes of section 15G of the Exchange Act; and (ii) does not include a security that is issued by a finance subsidiary and held by the parent company of the finance subsidiary or a company that is controlled by such parent company provided that none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company.

[31] See proposed rules at §__.2 (definition of "asset-backed security").

[32] See proposed rules at §__.2 (definition of "asset"). Because the term "asset-backed security" for purposes of section 15G includes only those securities that are collateralized by self-liquidating financial assets, "synthetic" securitizations are not within the scope of the proposed rules.

defines the term "securitized asset" to mean an asset that is transferred, sold, or conveyed to an issuing entity and that collateralizes the ABS interests issued by the issuing entity.[33]

Section 15G does not appear to distinguish between transactions that are registered with the Commission under the Securities Act of 1933 (the "Securities Act") and those that are exempt from registration under the Securities Act. For example, section 15G provides authority for exempting from the risk retention requirements certain securities that are exempt from registration under the Securities Act.[34] In addition, the statutory definition of asset-backed security is broader than the definition of asset-backed security in the Commission's Regulation AB,[35] which governs the disclosure requirements for ABS offerings that are registered under the Securities Act.[36] The definition of asset-backed security for purposes of section 15G also includes securities that are typically sold in transactions that are exempt from registration under the Securities Act, such as CDOs, as well as securities issued or guaranteed by a government

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[33] See proposed rules at § __.2. Assets or other property collateralize an issuance of ABS interests if the assets or property serves as collateral for such issuance. Assets or other property serve as collateral for an ABS issuance if they provide the cash flow for the ABS interests issued by the issuing entity (regardless of the legal structure of the issuance), and may include security interests in assets or other property of the issuing entity, fractional undivided property interests in the assets or other property of the issuing entity, or any other property interest in such assets or other property. The term collateral includes leases that may convert to cash proceeds from the disposition of the physical property underlying the assets. The cash flow from an asset includes any proceeds of a foreclosure on, or sale of, the asset. See proposed rules at § __.2 (definition of "collateral" for an ABS transaction).

[34] See, e.g., 15 U.S.C. 78o-11(c)(1)(G) (authorizing exemptions from the risk retention requirements certain transactions that are typically exempt from Securities Act registration); 15 U.S.C. 78o-11(e)(3)(B)(providing for certain exemptions for certain assets, or securitizations based on assets, which are insured or guaranteed by the United States).

[35] 17 CFR 229.1100 through 17 CFR 229.1123.

[36] See 15 U.S.C. § 78b.

sponsored entity (GSE), such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). In light of the foregoing, the proposed risk retention requirements would apply to securitizers of ABS offerings whether or not the offering is registered with the Commission under the Securities Act.

As discussed further below, the proposed rules generally apply the risk retention requirements to the securitizer in each "securitization transaction," which is defined as a transaction involving the offer and sale of ABS by an issuing entity.[37] Applying the risk retention requirements to the securitizer of each issuance of ABS ensures that the requirements apply in the aggregate to all ABS issued by an issuing entity, including an issuing entity—such as a master trust—that issues ABS periodically.

The proposed rules use the term "ABS interest" to refer to all types of interests or obligations issued by an issuing entity, whether or not in certificated form, including a security, obligation, beneficial interest or residual interest, the payments on which are primarily dependent on the cash flows on the collateral held by the issuing entity. The term, however, does not include common or preferred stock, limited liability interests, partnership interests, trust certificates, or similar interests in an issuing entity that are issued primarily to evidence ownership of the issuing entity, and the payments, if any, on

[37] An "issuing entity" is defined to mean, with respect to a securitization transaction, the trust or other entity created at the direction of the sponsor that owns or holds the pool of assets to be securitized, and in whose name the ABS are issued. See proposed rules at § __.2.

which are not primarily dependent on the cash flows of the collateral held by the issuing entity.[38]

B. Securitizer, sponsor, and depositor

Section 15G generally provides for the Agencies to apply the risk retention requirements of the statute to a "securitizer" of ABS. Section 15G(a)(3) in turn provides that the term "securitizer" with respect to an issuance of ABS includes both "(A) an issuer of an asset-backed security; or (B) a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer."[39]

The Agencies note that the second prong of this definition (i.e., the person who organizes and initiates the ABS transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer) is substantially identical to the definition of a "sponsor" of a securitization transaction in the Commission's Regulation AB governing disclosures for ABS offerings registered under the Securities Act.[40] In light of this, the proposed rules provide that a "sponsor" of an ABS transaction

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[38] See proposed rules at § __.2. In securitization transactions where ABS interests are issued and some or all of the cash proceeds of the transaction are retained by the issuing entity to purchase, during a limited time period after the closing of the securitization, self-liquidating financial assets to support the securitization, the terms "asset," "collateral," and "securitized assets" should be construed to include such cash proceeds as well as the assets purchased with such proceeds and any assets transferred to the issuing entity on the closing date. Accordingly, the terms "asset-backed security" and "ABS interest" should also be construed to include securities and other interests backed by such proceeds. Such securitization transactions are commonly referred to as including a "pre-funding account."

[39] See 15 U.S.C. § 78o-11(a)(3).

[40] See Item 1101 of the Commission's Regulation AB (17 CFR 229.1101) (defining a sponsor as "a person who organizes and initiates an asset-backed securities transaction by

is a "securitizer" for the purposes of section 15G, and define the term "sponsor" in a manner consistent with the definition of that term in the Commission's Regulation AB.[41]

The proposal would, as a general matter, require that a sponsor of a securitization transaction retain the credit risk of the securitized assets in the form and amount required by the proposed rules. The Agencies believe that proposing to apply the risk retention requirement to the sponsor of the ABS—as permitted by section 15G—is appropriate in light of the active and direct role that a sponsor typically has in arranging a securitization transaction and selecting the assets to be securitized.[42] In circumstances where two or more entities each meet the definition of sponsor for a single securitization transaction, the proposed rules would require that one of the sponsors retain a portion of the credit risk of the underlying assets in accordance with the requirements of this proposal.[43] Each sponsor in the transaction, however, would remain responsible for ensuring that at least one sponsor complied with the requirements.

As noted above, the definition of "securitizer" in section 15G(a)(3)(A) includes the "issuer of an asset-backed security." The term "issuer" when used in the federal securities laws may have different meanings depending on the context in which it is used.

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selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity.")

41 See proposed rules at § __.2. Consistent with the Commission's definition of sponsor, the Agencies interpret the term "issuer" as used in section 15G(a)(3)(B) to refer to the issuing entity that issues the ABS.

42 For example, in the context of collateralized loan obligations (CLOs), the CLO manager generally acts as the sponsor by selecting the commercial loans to be purchased by an agent bank for inclusion in the CLO collateral pool, and then manages the securitized assets once deposited in the CLO structure.

43 See proposed rules at § __.3(a). Because the term sponsor is used throughout the proposed rules, the term is separately defined in § __.2 of the proposed rules. The definition of "sponsor" in § __.2 is identical to the sponsor part of the proposed rules' definition of a "securitizer."

For example, for several purposes under the federal securities laws, including the Securities Act[44] and the Exchange Act[45] and the rules promulgated under these Acts,[46] the term "issuer" when used with respect to an ABS transaction is defined to mean the entity—the depositor—that deposits the assets that collateralize the ABS with the issuing entity. The Agencies interpret the reference in section 15G(a)(3)(A) to an "issuer of an asset-backed security" as referring to the "depositor" of the ABS, consistent with how that term has been defined and used under the federal securities laws in connection with ABS.[47] As noted above, the proposed rules generally would apply the risk retention requirements of section 15G to a sponsor of a securitization transaction (and not the depositor for the securitization transaction).

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44 Section 2(a)(4) of Securities Act (15 U.S.C. § 77b(a)(4)) defines the term "issuer" in part to include every person who issues or proposes to issue any security, except that with respect to certificates of deposit, voting-trust certificates, or collateral trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors (or persons performing similar functions), the term issuer means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which the securities are issued.

45 See Exchange Act § 3(a)(8) (15 U.S.C. § 78c(a)(8) (defining "issuer" under the Exchange Act).

46 See, e.g., Securities Act Rule 191 (17 CFR 230.191) and Exchange Act Rule 3b-19 (17 CFR 240.3b-19).

47 For asset-backed securities transactions where there is not an intermediate transfer of the assets from the sponsor to the issuing entity, the term depositor refers to the sponsor. For asset-backed securities transactions where the person transferring or selling the pool assets is itself a trust (such as in an issuance trust structure), the depositor of the issuing entity is the depositor of that trust. See proposed rules at § __.2. Securities Act Rule 191 and Exchange Act Rule 3b-19 also note that the person acting as the depositor in its capacity as depositor to the issuing entity is a different ''issuer'' from that person in respect of its own securities in order to make clear -- for example -- that any applicable exemptions from Securities Act registration that person may have with respect to its own securities are not applicable to the asset-backed securities. That distinction does not appear relevant here.

C. Originator

As permitted by section 15G, §__.13 of the proposed rules permit a sponsor to allocate its risk retention obligations to the originator(s) of the securitized assets in certain circumstances and subject to certain conditions. The proposed rules define the term originator in the same manner as section 15G, that is, as a person who, through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security, and sells the asset directly or indirectly to a securitizer (i.e., a sponsor or depositor). Because this definition refers to the person that "creates" a loan or other receivable, only the original creditor under a loan or receivable—and not a subsequent purchaser or transferee—is an "originator" of the loan or receivable for purposes of section 15G.[48]

Request for Comment

1. Do the proposed rules appropriately implement the terms "securitizer" and "originator" as used in section 15G and consistent with its purpose?

2. Are there other terms, beyond those defined in §__.2 of the proposed rules, that the Agencies should define?

3(a). As a general matter, is it appropriate to impose the risk retention requirements on the sponsor of an ABS transaction, rather than the depositor for the transaction? 3(b). If not, why?

4(a). With respect to the terms defined, would you define any of the terms differently? 4(b). If so, which ones would you define differently, and how would you define them? For example, credit risk is defined to mean, among other things, the risk of

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48 See 15 U.S.C. § 78o-11(a)(3).

loss that could result from failure of the issuing entity to make required payments or from bankruptcy of the issuing entity.

5. Is it appropriate for the definition of credit risk to include risk of non-payment by the issuing entity unrelated to the assets, such as risk that the issuing entity is not bankruptcy remote?

6. Are all of the definitions in §__.2 of the proposed rules necessary? For instance, is a definition of "asset" necessary?

7(a). As proposed, where two or more entities each meet the definition of sponsor for a single securitization transaction, the proposed rules would require that one of the sponsors retain a portion of the credit risk of the underlying assets in accordance with the requirements of the rules. Is this the best approach to take when there are multiple sponsors in a single securitization transaction? 7(b). If not, what is a better approach and why? For example, should all sponsors be required to retain credit risk in some proportional amount, should the sponsor selling the greatest number of assets or with a particular attribute be required to retain the risk, or should the proposed rules only allow a sponsor that has transferred a minimum percentage (e.g., 10 percent, 20 percent, or 50 percent) of the total assets into the trust to retain the risk?

8(a). Should the proposed rules allow for allocation of risk to a sponsor (among multiple sponsors in a single transaction) similar to the proposed rules' parameters for allocation of risk among multiple originators? 8(b). Why or why not?

9. A securitization transaction is proposed to be defined as a transaction involving the offer and sale of asset-backed securities by an issuing entity. In a single securitization transaction, there may be intermediate steps; however, the proposed rules

would only require the sponsor to retain risk for the securitization transaction as a whole.[49] Should the rules provide additional guidance for when a transaction with intermediate steps constitutes one or more securitization transactions that each should be subject to the rules' risk retention requirements?

III. General Risk Retention Requirement

A. Minimum 5 percent risk retention required

Section 15G of the Exchange Act generally requires that the Agencies jointly prescribe regulations that require a securitizer to retain not less than five percent of the credit risk for any asset that the securitizer, through the issuance of an ABS, transfers, sells, or conveys to a third party, unless an exemption from the risk retention requirements for the securities or transaction is otherwise available (e.g., if the ABS is collateralized exclusively by QRMs). Consistent with the statute, the proposed rules generally would require that a sponsor retain an economic interest equal to at least five percent of the aggregate credit risk of the assets collateralizing an issuance of ABS (the "base" risk retention requirement).[50] This exposure should provide a sponsor with an

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[49] For example, in auto lease securitizations, the auto leases and car titles are originated in the name of a separate trust to avoid the administrative expenses of retitling the physical property underlying the leases. The separate trust will issue to the issuing entity for the asset-backed security a collateral certificate, often called a ''special unit of beneficial interest'' (SUBI). The issuing entity will then issue the asset-backed securities backed by the SUBI certificate.

[50] See proposed rules at §__.3 through §__.11. We note that the proposed rules, in some instances, permit a sponsor to allow another person to retain the required amount of credit risk (e.g., originators, third-party purchasers in commercial mortgage-backed securities transactions, and originator-sellers in asset-backed commercial paper conduit securitizations). However, in such circumstances the proposal includes limitations and conditions designed to ensure that the purposes of section 15G continue to be fulfilled. Further, we note that even when a sponsor would be permitted to allow another person to

incentive to monitor and control the quality of the assets being securitized and help align the interests of the sponsor with those of investors in the ABS. As discussed in Part III.D of this Supplementary Information, the sponsor also would be prohibited from hedging or otherwise transferring this retained interest.

As required by section 15G, the proposed risk retention requirements would apply to all ABS transactions that are within the scope of section 15G, regardless of whether the sponsor is an insured depository institution, a bank holding company or subsidiary thereof, a registered broker-dealer, or other type of federally supervised financial institution. Thus, for example, it would apply to securitization transactions by any nonbank entity that is not an insured depository institution (such as an independent mortgage firm), as well as by Fannie Mae and Freddie Mac.

The Agencies note that the five percent risk retention requirement established by the proposed rules would be a regulatory minimum. The sponsor, originator, or other party to a securitization may retain, or be required to retain, additional exposure to the credit risk of assets that the sponsor, originator, or other party helps securitize beyond that required by the proposed rules, either on its own initiative or in response to the demands of private market participants. Moreover, the proposed rules would require that a sponsor, in certain circumstances, fund a premium capture cash reserve account in connection with a securitization transaction (see Part III.B.9 of this Supplementary Information). Any amount a sponsor might be required to place in a premium capture cash reserve account would be in addition to the five percent "base" risk retention requirement of the proposed rules.

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retain risk, the sponsor would still remain responsible under the rule for compliance with the risk retention requirements.

Request for Comment

10. The Agencies request comment on whether the minimum five percent risk retention requirement established by the proposed rules for non-exempt ABS transactions is appropriate, or whether a higher risk retention requirement should be established for all non-exempt ABS transactions or for any particular classes or types of non-exempt ABS.

11. If a higher minimum requirement should be established, what minimum should be established and what factors should the Agencies take into account in determining that higher minimum? For example, should the amount of credit risk be based on expected losses, or a market-based test based on the interest rate spread relative to a benchmark index?

12(a). Would the minimum five percent risk retention requirement, as proposed to be implemented, have a significant adverse effect on liquidity or pricing in the securitization markets for certain types of assets (such as, for example, prudently underwritten residential mortgage loans that do not satisfy all of the requirements to be a QRM)? 12(b). If so, what markets would be adversely affected and how? What adjustments to the proposed rules (e.g., the minimum risk retention amount, the manner in which credit exposure is measured for purposes of applying the risk retention requirement, or the form of risk retention) could be made to the proposed rules to address these concerns in a manner consistent with the purposes of section 15G? Please provide details and supporting data.

B. Permissible Forms of Risk Retention

As recognized in recent studies and reports on securitization and risk retention that have examined historical market practices, there are several ways in which a sponsor or other entity may have retained exposure to the credit risk of securitized assets.[51] These include (i) a "vertical" slice of the ABS interests, whereby the sponsor or other entity retains a specified pro rata piece of every class of interests issued in the transaction; (ii) a "horizontal" first-loss position, whereby the sponsor or other entity retains a subordinate interest in the issuing entity that bears losses on the assets before any other classes of interests; (iii) a "seller's interest" in securitizations structured using a master trust collateralized by revolving assets whereby the sponsor or other entity holds a separate interest that is pari passu with the investors' interest in the pool of receivables (unless and until the occurrence of an early amortization event); or (iv) a representative sample, whereby the sponsor retains a representative sample of the assets to be securitized that exposes the sponsor to credit risk that is equivalent to that of the securitized assets. These examples are not exclusive.

The various forms of risk retention have developed, in part, due to the diversity of assets that are securitized and the structures commonly used in securitizing different types of assets. For example, due to the revolving nature of credit card accounts and the fact that multiple series of ABS collateralized by credit card receivables typically are issued using a single master trust structure, sponsors of ABS transactions collateralized by credit card receivables often have maintained exposure to the credit risk of the underlying loans through use of a seller's interest. On the other hand, sponsors of ABS backed by automobile loans where the originator of the loan is often a finance company

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[51] See Board Report; see also Macroeconomic Effects of Risk Retention Requirements, Chairman of the Financial Stability Oversight Counsel (January 2011), available at http://www.treasury.gov/initiatives/wsr/Documents/Section 946 Risk Retention Study (FINAL).pdf.

affiliated with the sponsor will often retain a portion of the loans that would ordinarily be securitized, thus providing the sponsor some continuing exposure to the credit risk of those loans. In connection with the securitization of commercial mortgage-backed securities ("CMBS"), a form of horizontal risk retention often has been employed, with the horizontal first-loss position being initially held by a third-party purchaser that specifically negotiates for the purchase of the first-loss position and conducts its own credit analysis of each commercial loan backing the CMBS.[52] Sponsors across a wide range of asset classes may initially hold a horizontal piece of the securitization (such as a residual interest). Different forms of risk retention also may have different accounting implications for a sponsor or other entity.[53] Historically, whether or how a sponsor retained exposure to the credit risk of the assets it securitized was determined by a variety of factors including the rating requirements of the NRSROs, investor preferences or demands, accounting considerations, and whether there was a market for the type of interest that might ordinarily be retained (at least initially by the sponsor).

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[52] Section 15G(c)(1)(E) allows the Federal banking agencies and the Commission to determine that with respect to CMBS, a form of retention that satisfies the requirements includes retention of a first-loss position by a third-party purchaser that meets certain criteria. See 15 U.S.C. § 78o-11(c)(1)(E).

[53] The determination whether a legal entity established to issue ABS must be included in the consolidated financial statements of the sponsor or another participant in the securitization chain is primarily addressed by the following generally accepted accounting principles issued by the Financial Accounting Standards Board (FASB): Accounting Standards Codification Topic 860, Transfers and Servicing (ASC 860, commonly called FAS 166); and FASB Accounting Standards Codification Topic 810, Consolidation (ASC 810, commonly called FAS 167). ASC 860 addresses whether securitizations and other transfers of financial assets are treated as sales or financings. ASC 810 addresses whether legal entities often used in securitization and other structured finance transactions should be included in the consolidated financial statements of any one of the parties involved in the transaction. Together, this guidance determines the extent to which an originator, sponsor, or another company is required to maintain securitized assets and corresponding liabilities on their balance sheets.

Section 15G expressly provides the Agencies the authority to determine the permissible forms through which the required amount of risk retention must be held.[54] Consistent with this flexibility, Subpart B of the proposed rules would provide sponsors with multiple options to satisfy the risk retention requirements of section 15G. The options in the proposed rules are designed to take into account the heterogeneity of securitization markets and practices, and to reduce the potential for the proposed rules to negatively affect the availability and costs of credit to consumers and businesses. However, importantly, each of the permitted forms of risk retention included in the proposed rules is subject to terms and conditions that are intended to help ensure that the sponsor (or other eligible entity) retains an economic exposure equivalent to at least five percent of the credit risk of the securitized assets. Thus, the forms of risk retention would help to ensure that the purposes of section 15G are fulfilled. In addition, as discussed further in Part III.D of this Supplementary Information below, the proposed rules would prohibit a sponsor from transferring, selling or hedging the risk that the sponsor is required to retain, thereby preventing sponsors from circumventing the requirements of the rules by selling or transferring the risk after the securitization transaction has been completed. The proposed rules also include disclosure requirements that are an integral part of and specifically tailored to each of the permissible forms of risk retention. The disclosure requirements are integral to the proposed rules because they would provide investors with material information concerning the sponsor's retained interests in a

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[54] See 15 U.S.C. § 78o-11(c)(1)(C)(i); see also S. Rep. No. 111-176, at 130 (2010) ("The Committee [on Banking, Housing, and Urban Affairs] believes that implementation of risk retention obligations should recognize the differences in securitization practices for various asset classes.").

securitization transaction, such as the amount and form of interest retained by sponsors, and the assumptions used in determining the aggregate value of ABS to be issued (which generally affects the amount of risk required to be retained). Further, the disclosures are also integral to the rule because they would provide investors and the Agencies with an efficient mechanism to monitor compliance with the risk retention requirements of the proposed rules.[55]

Request for Comment

13. Is the proposed menu of options approach to risk retention, which would allow a sponsor to choose the form of risk retention (subject to all applicable terms and conditions), appropriate?

14(a). Should the Agencies mandate that sponsors use a particular form of risk retention (e.g., a vertical slice or a horizontal slice) for all or specific types of asset classes or specific types of transactions? 14(b). If so, which forms should be required for with which asset classes and why?

15. Does the proposed menu approach achieve the objectives of the statute to provide securitizers an incentive to monitor and control the underwriting quality of securitized assets and help align incentives among originators, sponsors, and investors?

16. Is each of the proposed forms of risk retention appropriate? In particular, the Agencies seek comment on the potential effectiveness of the proposed forms of risk

[55] The Agencies note that a variation of the vertical, horizontal, seller's interest and representative sample options described below are forms of eligible risk retention in the proposed European Union capital requirement directive relating to securitizations. See "Call for Technical Advice on the Effectiveness of a Minimum Retention Requirement for Securitizations," Committee of European Bank Supervisors (October 30, 2009) (CEBS proposal).

retention in achieving the purposes of section 15G, their potential effect on securitization markets, and any operational or other problems these forms may present.

17. Are there any kinds of securitizations for which a particular form of risk retention is not appropriate?

18. How effective would each of the proposed risk retention options be in creating incentives to monitor and control the quality of assets that are securitized and in aligning the interests among the parties in a securitization transaction?

19(a). Are there other forms of risk retention that the Agencies should permit? 19(b). If so, please provide a detailed description of the form(s), how such form(s) could be implemented, and whether such form(s) would be appropriate for all, or just certain, classes of assets.

20. Should the proposed rules require disclosure as to why the sponsor chose a particular risk retention option?

21(a). Are there ways that sponsors could avoid the risk retention requirements in an effort to reduce or eliminate their risk retention requirements? 21(b). If so, how should we modify the proposed rules to address this potential?

22. Are the methodologies proposed for calculating the required five percent exposure under each of the options appropriate?

23(a). Are there other ways that the minimum five percent requirement should be calculated? 23(b). Would such calculation methods be difficult to enforce? 23(c). If so, how can we address those difficulties? 23(d). Are there other alternatives?

1. Vertical risk retention

As proposed, a sponsor may satisfy its risk retention requirements with respect to a securitization transaction by retaining at least five percent of each class of ABS interests issued as part of the securitization transaction.[56] A sponsor using this approach must retain at least five percent of each class of ABS interests issued in the securitization transaction regardless of the nature of the class of ABS interests (e.g., senior or subordinated) and regardless of whether the class of interests has a par value, was issued in certificated form, or was sold to unaffiliated investors. For example, if four classes of ABS interests were issued by an issuing entity as part of a securitization—a senior AAA-rated class, a subordinated class, an interest-only class, and a residual interest—a sponsor using this approach with respect to the transaction would have to retain at least five percent of each such class or interest.[57] The proposed rules do not specify a method of measuring the amount of each class, because the amount retained, regardless of method of measurement, should equal at least five percent of the par value (if any), fair value, and number of shares or units of each class.

Under the vertical risk retention option, by holding a five percent vertical slice in an ABS issuance, a sponsor is exposed to five percent of the credit risk that each class of investors has to the underlying collateral. This provides the sponsor an interest in the entire structure of the securitization transaction.

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[56] See proposed rules at § __.4.

[57] As noted previously, the proposed definition of ABS interests does not include common or preferred stock, limited liability interests, partnership interests, trust certificates or similar interests that are issued primarily to evidence ownership of the issuing entity and the payments, if any, on which are not primarily dependent on the cash flows of the assets of the issuing entity. See proposed rules at § __.2 (definition of "ABS interests").

Under the proposed rules, a sponsor that elects to retain risk through the vertical slice option would be required to provide, or cause to be provided, to potential investors a reasonable time prior to the sale of the asset-backed securities in the securitization transaction and, upon request, to the Commission and to its appropriate Federal banking agency (if any), the amount (expressed as a percentage and a dollar amount) of each class of ABS interests in the issuing entity that the sponsor will retain (or did retain) at closing as well as the amount (expressed, again, as a percentage and dollar amount) that the sponsor is required to retain under the proposed rules. This disclosure would allow investors to know what risk the sponsor will actually retain in the transaction and compare this amount to the risk that the sponsor is required to retain under the proposed rules. In addition, the proposed rules would require a sponsor to disclose, or cause to be disclosed, the material assumptions and methodologies it used to determine the aggregate dollar amount of ABS interests issued by the issuing entity in the securitization transaction, including those pertaining to any estimated cash flows and the discount rate used. Disclosure of these assumptions and methodologies should help investors and the Agencies monitor the sponsor's compliance with its risk retention requirements because the five percent risk retention requirement is based on the aggregate amount of each class of ABS interests issued as part of the transaction.[58]

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[58] For similar reasons, disclosure of such assumptions and methodologies would be required under the other risk retention options where the amount of the sponsor's required amount of risk retention is based on the amount of interests issued by the issuing entity or the amount of the collateral underlying such interests. Depending on the circumstances, a sponsor may have an incentive to inflate the value of the underlying collateral and the ABS supported by such collateral (for example, to increase the proceeds from the securitization transaction) or to underestimate the value of such collateral and ABS (for example, to reduce the sponsor's risk retention requirement). The material assumptions relating to estimated cash flows likely would include those

Request for Comment

24. Are the disclosures proposed sufficient to provide investors with all material information concerning the sponsor's retained interest in a securitization transaction, as well as to enable investors and the Agencies to monitor the sponsor's compliance with the rule?

25(a). Should additional disclosures be required? 25(b). If so, what should be required and why?

26. Are there any additional factors, such as cost considerations, that the Agencies should consider in formulating an appropriate vertical risk retention option?

2. Horizontal risk retention

As proposed, the second risk retention option permits a sponsor to satisfy its risk retention obligations by retaining an "eligible horizontal residual interest" in the issuing entity in an amount that is equal to at least five percent of the par value of all ABS interests in the issuing entity that are issued as part of the securitization transaction.[59] As discussed below, the eligible horizontal residual interest would expose the sponsor to a five percent first-loss exposure to the credit risk of the entire pool of securitized assets.

The proposed rules include a number of terms and conditions governing the structure of an eligible horizontal residual interest in order to ensure that the interest would be a "first-loss" position,[60] and could not be reduced in principal amount (other

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relating to the estimated default rate, prepayment rate, the time between default and recoveries on the underlying assets, as well as interest rate projections for assets with variable interest rates.

59 See proposed rules at § __.4.

60 As discussed in Part III.B.9 of this Supplemental Information, if a sponsor is required to establish and fund a premium capture cash reserve account in connection with a

than through the absorption of losses) more quickly than more senior interests and, thus, would remain available to absorb losses on the securitized assets. Specifically, an interest qualifies as an "eligible horizontal residual interest" under the proposed rules only if it is an ABS interest that is allocated all losses on the securitized assets until the par value of the class is reduced to zero and has the most subordinated claim to payments of both principal and interest by the issuing entity.[61]

Moreover, until all other ABS interests in the issuing entity are paid in full, the eligible horizontal residual interest generally cannot receive any payments of principal made on a securitized asset. However, the interest may receive its proportionate share of scheduled payments of principal received on the securitized assets in accordance with the relevant transaction documents. For example, so long as any other ABS interests are outstanding, a sponsor, through its ownership of the eligible horizontal residual interest, would be prohibited from receiving any prepayments of principal made on the underlying assets because these are, by definition, unscheduled payments. This sponsor also would be prohibited from receiving principal payments made on the underlying assets derived from proceeds from the sale of, or foreclosure on, an underlying asset. The prohibition of unscheduled payments to the eligible horizontal residual interest is designed to ensure that unscheduled payments would not accelerate the payoff of the eligible horizontal residual interest before other ABS interests. Such acceleration would reduce the capacity of the eligible horizontal residual interest to absorb losses on the securitized assets as well as the duration of the sponsor's interest in the securitized assets. The proposed rules

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securitization transaction, such account would first bear losses on the securitized assets (even before an eligible horizontal residual interest) until the account was depleted.

[61] See proposed rules at § __.2 (definition of "eligible horizontal residual interest").

would, however, permit the eligible horizontal residual interest to receive its pro rata share of scheduled principal payments on the underlying assets.[62]

Similar to the vertical slice risk retention option, under the proposed rules, a sponsor using the horizontal risk retention option would be required to provide, or cause to be provided, to potential investors a reasonable period of time prior to the sale of ABS interests in the issuing entity and, upon request, to the Commission and its appropriate Federal banking agency (if any): the amount (expressed as a percentage and dollar amount) of the eligible horizontal residual interest that will be retained (or was retained) by the sponsor at closing, and the amount (expressed as a percentage and dollar amount) of the eligible horizontal residual interest required to be retained by the sponsor in connection with the securitization transaction; a description of the material terms of the eligible horizontal residual interest, such as when such interest is allocated losses or may receive payments; and the material assumptions and methodologies used in determining the aggregate dollar amount of ABS interests issued by the issuing entity in the securitization transaction, including those pertaining to any estimated cash flows and the discount rate used.

In lieu of holding an eligible horizontal residual interest, the proposed rules would allow a sponsor to cause to be established and funded, in cash, a reserve account at closing (horizontal cash reserve account) in an amount equal to at least five percent of the

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62 Thus, an eligible horizontal residual interest with a par value of five percent of the aggregate par value of all ABS interests could, subject to its most subordinate place in the payments waterfall, (i) initially be entitled to receive up to five percent of scheduled principal payments received on the securitized assets, and (ii) if losses reduced the par value of the interest to three percent, receive no more than three percent of scheduled principal payments received on the securitized assets.

par value of all the ABS interests issued as part of the transaction (i.e., the same dollar amount as would be required if the sponsor held an eligible horizontal residual interest).[63] This horizontal cash reserve account would have to be held by the trustee (or person performing functions similar to a trustee) for the benefit of the issuing entity. The proposed rules include several important restrictions and limitations on such a horizontal cash reserve account. These limitations and restrictions are intended to ensure that a sponsor that establishes a horizontal cash reserve account would be exposed to the same amount and type of first-loss credit risk on the underlying assets as would be the case if the sponsor held an eligible horizontal residual interest.

Specifically, the proposed rules would provide that, until all ABS interests in the issuing entity are paid in full or the issuing entity is dissolved, the horizontal cash reserve account must be used to satisfy payments on ABS interests on any payment date when the issuing entity has insufficient funds from any source (including any premium capture cash reserve account established under § ____.12 of the proposed rules) to satisfy an amount due on any ABS interest.[64] Thus, the amounts in the account would bear first loss on the securitized assets in the same way as an eligible horizontal residual interest. In addition, until all ABS interests in the issuing entity are paid in full or the issuing entity is dissolved, the proposed rules would prohibit any other amounts from being withdrawn or distributed from the account, with only two exceptions. The first exception would allow amounts in the account to be released to the sponsor (or any other person) due to receipt by the issuing entity of scheduled payments of principal on the securitized

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[63] See proposed rules at §__.4(b).

[64] See proposed rules at §__.4(b)(3)(i).

assets, provided that the issuing entity distributes such payments of principal in accordance with the transaction documents and the amount released from the horizontal cash reserve account on any date does not exceed the product of: (i) the amount of scheduled payments of principal on the securitized assets received by the issuing entity and for which the release is being made; and (ii) the ratio of the current balance in the horizontal cash reserve account to the aggregate remaining principal balance of all ABS interests in the issuing entity. This limitation is intended to ensure that, like an eligible horizontal residual interest, a horizontal cash reserve account would not be depleted by unscheduled payments of principal on the underlying assets. The second exception would be that the sponsor would be permitted to receive interest payments (but not principal payments) received by the horizontal cash reserve account on its permitted investments.[65]

A sponsor electing to establish and fund a horizontal cash reserve account would be required to provide disclosures similar to those required with respect to an eligible horizontal residual interest, except that these disclosures have been modified to reflect the different nature of the account.

<u>Request for Comment</u>

27. Do the conditions and limitations in the proposed rules effectively limit the ability of the sponsor to structure away its risk exposure?

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[65] Under the proposed rules, amounts in a horizontal cash reserve account may only be invested in (i) United States Treasury securities with remaining maturities of 1 year or less; and (ii) deposits in one or more insured depository institutions (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)) that are fully insured by federal deposit insurance. <u>See</u> proposed rules at §__.4(b)(2).

28(a). Is the restriction on certain payments to the sponsor with respect to the eligible horizontal residual interest appropriate and sufficient? 28(b). Why or why not?

29(a). Is the proposed approach to measuring the size of horizontal risk retention (five percent of the par value of all ABS interests in the issuing entity that are issued as part of the securitization transaction) appropriate? 29(b). Would a different measurement be better? Please provide details and data supporting any alternative measurements.

30. Are the disclosures proposed sufficient to provide investors with all material information concerning the sponsor's retained interest in a securitization transaction, as well as enable investors and the Agencies to monitor whether the sponsor has complied with the rule?

31(a). Should additional disclosures be required? 31(b). If so, what should be required and why?

32. Are there any additional factors, such as accounting or cost considerations that the Agencies should consider with respect to horizontal risk retention?

33. Should a sponsor be prohibited from utilizing the horizontal risk retention option if the sponsor (or an affiliate) acts as servicer for the securitized assets?

34. Are the terms and conditions of the horizontal cash reserve account appropriate?

35. Do the terms and conditions ensure that such an account will expose the sponsor to the same type and amount of credit risk and have the same incentive effects as an eligible horizontal residual interest?

36(a). Should the eligible horizontal residual interest be required to be structured as a "Z bond" such that it pays no interest while principal is being paid down on more senior interests? 36(b). Why or why not?

3. L-Shaped risk retention

The next risk retention option in the proposed rules would allow a sponsor, subject to certain conditions, to use an equal combination of vertical risk retention and horizontal risk retention as a means of retaining the required five percent exposure to the credit risk of the securitized assets. This form of risk retention is referred to as an "L-Shaped" form of risk retention because it combines both vertical and horizontal forms. Specifically, § __.6 of the proposed rules would allow a sponsor to meet its risk retention obligations under the rules by retaining:

(i) Not less than 2.5 percent of each class of ABS interests in the issuing entity issued as part of the securitization transaction (the vertical component); and

(ii) An eligible horizontal residual interest in the issuing entity in an amount equal to at least 2.564 percent of the par value of all ABS interests in the issuing entity issued as part of the securitization transaction, other than those interests required to be retained as part of the vertical component (the horizontal component).[66]

The amount of the horizontal component is calibrated to avoid double counting that portion of an eligible horizontal residual interest that the sponsor is required to hold

[66] As under the horizontal risk retention option itself, a sponsor would have the option of establishing and funding, in cash, a horizontal cash reserve account at the closing of the securitization transaction in this amount rather than holding an eligible horizontal residual interest. See proposed rules at §__.4(b). Any such horizontal cash reserve account would be subject to the same restrictions and limitations as under the horizontal risk retention option.

as part of the vertical component. This calibration also ensures that the combined amount of the vertical component and the horizontal component would be five percent of the aggregate transaction. For example, in a securitization transaction structured with three classes of interests: a certificated senior class whose par value is equal to $950, an uncertificated subordinated class of $24 and an uncertificated eligible horizontal residual interest whose par value is equal to $26, a sponsor would be required to retain $23.75 of the senior class ($950*2.5%), $0.60 of the subordinated class ($24*2.5%) and $25.65 of the eligible horizontal residual interest (($26*2.5%) + ($1000 – ($23.75 + $0.60 + $0.65))*2.564%) for a total of $50 in risk retention requirements. Because the required size of the sponsor's retained eligible horizontal residual interest ($25.65) is less than the amount of the eligible horizontal residual interest, retention of the entire horizontal residual interest by the sponsor complies with the minimum L-shape retention requirements for the securitization.[67]

The proposal would require that a sponsor hold 50 percent of its required risk retention amount in the form of a vertical component and 50 percent in the form of a horizontal component in order to help ensure that each component is large enough to affect the sponsor's incentives and to help align the incentives of the sponsor and investors. In addition, requiring that each component represent 50 percent of the total minimum risk retention requirement should assist investors and the Agencies with monitoring compliance with the proposed rules.

Because a sponsor using the L-shape risk retention option would retain both a vertical and a horizontal component, the proposed rules would require that the sponsor

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[67] This example is provided for simple illustration only.

provide the disclosures required under the vertical risk retention option, as well as those required under the horizontal risk retention option.

Request for Comment

37. Are the disclosures proposed sufficient to provide investors with all material information concerning the sponsor's retained interest in a securitization transaction, as well as enable investors and the Agencies to monitor whether the sponsor has complied with the rule?

38(a). Should additional disclosures be required? 38(b). If so, what should be required and why?

39. Are there any additional factors, such as cost considerations, that the Agencies should consider with respect to L-shape risk retention?

40(a). Should the Agencies permit or require that a higher proportion of the risk retention held by a sponsor under this option be composed of a vertical component or a horizontal component? 40(b). What implications might such changes have on the effectiveness of the option in helping achieving the purposes of section 15G?

4. Revolving asset master trusts (seller's interest)

Securitizations backed by revolving lines of credit, such as credit card accounts or dealer floorplan loans, often are structured using a revolving master trust, which allows the trust to issue more than one series of ABS backed by a single pool of the revolving assets.[68] In these types of transactions, the sponsor typically holds an interest known as a "seller's interest." This interest is pari passu with the investors' interest in the

[68] In a master trust securitization, assets (e.g., credit card receivables or dealer floorplan financings) may be added to the pool in connection with future issuances of the securities backed by the pool.

receivables backing the ABS interests of the issuing entity until the occurrence of an early amortization event. A seller's interest is a direct, shared interest with all of the investors in the performance of the underlying assets and, thus, exposes the sponsor to the credit risk of the pool or receivables.

In light of and to accommodate those types of securitizations, the proposed rules would allow a sponsor of a revolving asset master trust that is collateralized by loans or other extensions of credit that arise under revolving accounts to meet its base risk retention requirement by retaining a seller's interest in an amount not less than five percent of the unpaid principal balance of all the assets held by the issuing entity.[69] The proposed rules define a "revolving asset master trust" as an issuing entity that (i) is a master trust; and (ii) is established to issue more than one series of ABS, all of which are collateralized by a single pool of revolving securitized assets that are expected to change in composition over time. The proposed rules also define a "seller's interest" as an ABS interest (i) in all of the assets that are held by the issuing entity and that do not collateralize any other ABS interests issued by the entity; (ii) that is pari passu with all other ABS interests issued by the issuing entity with respect to the allocation of all payments and losses prior to an early amortization event (as defined in the transaction documents); and (iii) that adjusts for fluctuations in the outstanding principal balances of the securitized assets. The definitions of a seller's interest and a revolving asset master trust are intended to be consistent with market practices and, with respect to seller's interest, designed to ensure that any seller's interest retained by a sponsor under the proposal would expose the sponsor to the credit risk of the underlying assets.

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[69] See proposed rules at § __.7.

Under the proposed rules, a sponsor using the seller's interest option would be required to provide, or cause to be provided, in writing to potential investors a reasonable period of time prior to the sale of the asset-backed securities in the securitization transaction and, upon request, to the Commission and its appropriate Federal banking agency (if any) the amount (expressed as a percentage and dollar amount) of the seller's interest that the sponsor will retain (or has retained) in the transaction at closing and the amount (expressed as a percentage and dollar amount) that the sponsor is required to retain pursuant to §__.7 of the rule; a description of the material terms of the seller's interest; and the material assumptions and methodology used in determining the aggregate dollar amount of ABS interests issued by the issuing entity in the securitization transaction, including those pertaining to any estimated cash flows and the discount rate used.

Request for Comment

41(a). Should a sponsor of a revolving asset master trust be permitted to satisfy its base risk retention requirement by retaining the seller's interest, as proposed? 41(b). Why or why not?

42(a). Are there additional or different conditions that should be placed on this option? 42(b). If so, please explain in detail what other conditions would be appropriate.

43. Are there alternative methods of structuring risk retention for revolving asset master trust securitization transactions that should be permitted? Provide detailed descriptions and data or other support for any alternatives.

44. Are the proposed disclosures sufficient to provide investors with all material information concerning the sponsor's retained interest in a securitization transaction, as

well as enable investors and the Agencies to monitor whether the sponsor has complied with the rule?

45(a). Should additional disclosures be required? 45(b). If so, what should be required and why?

46. Should a seller's interest form of risk retention be applied to any other types of securitization transactions? If so, explain in detail and provide data or other support for application to other types of securitization transactions.

5. Representative sample

The next proposed risk retention option permits a sponsor of a securitization transaction to meet its risk retention requirements by retaining a randomly selected representative sample of assets that is equivalent, in all material respects, to the assets that are transferred to the issuing entity and securitized, subject to certain conditions.[70] This method of risk retention has been used in connection with securitizations involving automobile loans where the underlying loans are not originated purely for distribution, but are securitized by the sponsor as part of a broader funding strategy. By retaining a randomly selected representative sample of assets, the sponsor retains exposure to substantially the same type of credit risk as investors in the ABS. Therefore, this structure provides a sponsor incentives to monitor and control the quality of the underwriting of the securitized assets and helps align the sponsor's incentives with those of investors in the ABS.

Consistent with other risk retention options, a sponsor using the representative sample approach would be required to retain at least five percent of the credit risk of the

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[70] See proposed rules at § __.8.

assets the sponsor identifies for securitization. Therefore, the unpaid principal balance of all the assets in the representative sample would be required to equal at least five percent of the aggregate unpaid principal balance of all the assets in the pool of assets initially identified for securitization (including those that end up in the representative sample). For example, if the assets that are identified for securitization have an aggregate unpaid principal balance of $100 million, the aggregate unpaid principal balance of the assets in the representative sample would be required to equal at least $5 million.[71]

To ensure that a sponsor that retains a representative sample remains exposed to substantially the same aggregate credit risks as investors in the ABS, the proposal would require the sponsor to construct a representative sample according to a specific process. As an initial step, the sponsor would need to designate a pool of at least 1,000 separate assets for securitization (the "designated pool"). The representative sample would be required to be drawn exclusively from the designated pool. Also, the designated pool would be prohibited from containing any assets other than those that are either securitized or selected for the representative sample. In the second step, the sponsor must use a random selection process to identify those loans from within the designated pool that will be included in the representative sample. This random selection process may not take account of any characteristic of the assets other than their unpaid principal balance.

After the sponsor randomly selects a representative sample from the designated pool, it would be required to assess that sample to ensure that, for each material

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[71] Stated otherwise, the unpaid principal balance of the assets comprising the representative sample must be no less than 5/95ths (5.264 percent) of the aggregate unpaid principal balance of all the assets that ultimately are securitized in the securitization transaction. The proposed rules use this approach to defining the minimum size of a representative sample. See proposed rules at § __.8(b)(1)(i).

characteristic of the assets, including the average unpaid principal balance, in the designated pool the mean of any quantitative characteristic, and the proportion of any characteristic that is categorical in nature, of the sample of assets randomly selected from the designated pool is within a 95 percent two-tailed confidence interval of the mean or proportion, respectively, of the same characteristic of all the assets in the designated pool.[72]

Without these statistical tests, a sample could be biased towards, for example, assets with a larger dollar value or assets with a lower expected risk of default. In summary, this process is designed to ensure that the assets randomly selected from the designated pool are, in fact, representative of the securitized pool. If this process does not produce a sample with equivalent material characteristics (as measured by the required two-tailed confidence level), the sponsor must repeat it as necessary in order to achieve an equivalent result or rely on another permissible option for retaining credit risk. The proposal permits this re-selection and testing process.

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[72] Depending on the type of assets involved in the securitization, the material characteristics other than the unpaid principal balance of the assets might include, for example, the geographical location of the property securing the loan, the debt-to-income ratio(s) of the borrower (DTI ratio), and the interest rate payable on the loan. Characteristics such as the DTI ratio and the interest rate payable on the loan would be considered quantitative characteristics, and characteristics such as the geographic location of the property securing the loan would be considered categorical characteristics. Assuming the factors above are material, a sponsor using the representative sample option would be required to test the <u>mean</u> of the DTI ratio of loans in the representative sample against the <u>mean</u> of the DTI ratio of all assets in the designated pool (including the ones selected for the random sample). In addition, the sponsor would be required to test the <u>proportion</u> of the number of assets from one geographic location in the representative sample to the total number of assets in the representative sample against the <u>proportion</u> of the number of assets from the same geographic location in the designated pool to the total number of assets in the designated pool.

The proposal contains a variety of safeguards to ensure that the sponsor has constructed the representative sample in conformance with the requirements described above. For example, the sponsor would be required to have in place, and adhere to, policies and procedures for (i) identifying and documenting the material characteristics of the assets in the designated pool; (ii) selecting assets randomly from the designated pool for inclusion in the representative sample; (iii) testing the randomly selected sample of assets in the designated pool; (iv) maintaining, until all ABS interests are paid in full, documentation that clearly identifies the assets included in the representative sample; and (v) prohibiting, until all ABS interests are paid in full, assets in the representative sample from being included in the designated pool of any other securitization transaction.

In addition, prior to the sale of the asset-backed securities as part of the securitization transaction, the sponsor would be required to obtain an agreed upon procedures report from an independent, public accounting firm. At a minimum, the independent, public accounting firm must report on whether the sponsor has the policies and procedures mentioned above.[73] Once an acceptable agreed upon procedures report has been obtained, the sponsor may rely on such report for subsequent securitizations. However, if the sponsor's policies and procedures change in any material respect, a new agreed upon procedures report would be required. Under the proposal, the independent public accounting firm providing the agreed upon procedures report must report on the following minimum items:

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[73] See proposed rules at § __.8(d)(2)(i)-(v).

(i) Policies and procedures that require the sponsor to identify and document the material characteristics of assets included in a designated pool of assets that meets the requirements of the proposal;

(ii) Policies and procedures that require the sponsor to select assets randomly in accordance with the proposal;

(iii) Policies and procedures that require the sponsor to test the randomly-selected sample of assets in accordance with the proposal of this section;

(iv) Policies and procedures that require the sponsor to maintain, until all ABS interests are paid in full, documentation that identifies the assets in the representative sample established in accordance with the proposal; and

(v) Policies and procedures that require the sponsor to prohibit, until all ABS interests are paid in full, assets in the representative sample from being included in the designated pool of any other securitization transaction.

Because the performance of the assets included in the representative sample could differ from the performance of the securitized assets if the two sets of assets were serviced under different standards or procedures, the proposal provides that, until such time as all ABS interests in the issuing entity have been fully paid or the issuing entity has been dissolved, servicing of the assets included in the representative sample must be conducted by the same entity and under the same contractual standards as the servicing of the securitized assets. In addition, the individuals responsible for servicing the assets comprising the representative sample or the securitized assets must not be able to determine whether an asset is held by the sponsor or held by the issuing entity.

A sponsor would also be required to comply with the hedging, transfer and sale restrictions in section __.14 with respect to the assets in the representative sample. Additionally, the sponsor would be prohibited from removing any assets from the representative sample and, until all ABS interests are repaid, causing or permitting the assets in the representative sample to be included in any other designated pool or representative sample established in connection with any other securitization transaction.[74]

To help ensure that potential investors and the Agencies can monitor and assess the sponsor's compliance with these requirements, the proposal would require the sponsor to provide, or cause to be provided, the following disclosures to potential investors a reasonable period of time prior to the sale of asset-backed securities as part of the securitization transaction and to provide, or cause to be provided, the same information, upon request, to the Commission and its appropriate Federal banking agency (if any):

(i) The amount (expressed as a percentage of the designated pool and dollar amount) of assets included in the representative sample to be retained by the sponsor;

(ii) The amount (expressed as a percentage of the designated pool and dollar amount) of assets required to be included in the representative sample and retained by the sponsor;

(iii) A description of the material characteristics of the designated pool and the representative sample, including, but not limited to, the average unpaid principal balance of the assets in the designated pool and the representative sample, the means of the

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[74] See proposed rules at § __.8(f).

quantitative characteristics and proportions of characteristics that are categorical in nature with respect to each of the material characteristics of the assets in the designated pool and the representative sample, of appropriate introductory and explanatory information to introduce the characteristics, the methodology used in determining or calculating the characteristics, and any terms or abbreviations used;[75]

(iv) A description of the policies and procedures that the sponsor used for ensuring that the process for identifying the representative sample complies with the proposal and that the representative sample has equivalent material characteristics to those of the pool of securitized assets;

(v) Confirmation that an agreed upon procedures report was obtained as required by the proposal; and

(vi) The material assumptions and methodology used in determining the aggregate dollar amount of ABS interests issued by the issuing entity in the securitization transaction, including those pertaining to any estimated cash flows and the discount rate used.

Further, after the sale of the ABS, the sponsor would be required to provide, or cause to be provided, to investors at the end of each distribution period (as specified in the governing transaction documents) a comparison of the performance of the pool of securitized assets for the related distribution period with the performance of the assets in the representative sample for the related distribution period. A sponsor selecting the representative sample option also would be required to provide investors disclosure

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[75] See, e.g., disclosure of pool characteristics required in registered transactions in the Commission's Regulation AB, Item 1111(b).

concerning the assets in the representative sample in the same form, level, and manner as it provides, pursuant to rule or otherwise, concerning the securitized assets. Therefore, if loan-level disclosure concerning the securitized assets was required, by rule or otherwise, to be provided to investors, the same level of disclosure would also be required concerning the representative sample.

Request for Comment

47. Should we include the representative sample alternative as a risk retention option?

48. Are the mechanisms that we have proposed adequate to ensure monitoring of the randomization process if such an alternative were permitted?

49. Is the requirement that the designated pool contain at least 1000 assets appropriate, or should a greater number of assets be required or a lesser number be permitted?

50. Are there material characteristics other than the average unpaid principal balance of all the assets that should be identified in the rule for purposes of the equivalent risk determination and disclosure requirements?

51. Are there any better ways to ensure an adequate randomization process and the equivalence of the representative sample to the pool of securitized assets? For example, would it be appropriate and sufficient if the sponsor were required to use a third party to conduct the random selection with no subsequent testing to determine if the sample constructed has material characteristics equivalent to those of the securitized assets?

52(a). Alternatively, would it be adequate if the sponsor was required to provide a third-party opinion that the selection process was random and that retained exposures are equivalent (i.e., share a similar risk profile) to the securitized exposures? 52(b). Would this opinion resemble a credit rating, thereby raising concerns about undue reliance on credit ratings? 52(c). If this approach were adopted, should the Agencies impose any standards of performance to be followed by such a third party, or that such third party have certain characteristics?

53. If the Agencies adopt a representative sample option, should the same disclosures be required regarding the securitized assets subject to risk retention that are required for the assets in the pool at the time of securitization and on an ongoing basis?

54. Should the retained exposures, as proposed, be subject to the same servicing standards as the securitized exposures?

55. Are the disclosures proposed sufficient to provide investors with all material information concerning the sponsor's retained interest in a securitization transaction, as well as enable investors and the Agencies to monitor whether the sponsor has complied with the rule?

56(a): Should additional disclosures be required? 56(b). If so, what should be required and why?

57(a). Is the condition that a sponsor obtain an agreed upon procedures report from an independent, public accounting firm appropriate? 57(b). If not, is there another mechanism that should be included in the option that helps ensure that the sponsor has constructed the representative sample in conformance with the requirements of the rule?

58(a). Is the requirement that the sponsor determine equivalency with a 95 percent two-tailed confidence appropriate? 58(b). If not, what measurement of equivalency do you recommend and why?

6. Asset-backed commercial paper conduits

The next risk retention option under the proposed rules is an option specifically designed for structures involving asset-backed commercial paper (ABCP) that is supported by receivables originated by one or more originators and that is issued by a conduit that meets certain conditions.[76] This option is designed to take account of the special structures through which this type of ABCP typically is issued, as well as the manner in which exposure to the credit risk of the underlying assets typically is retained by participants in the securitization chain for this type of ABCP.

ABCP is a type of liability that is typically issued by a special purpose vehicle (or conduit) sponsored by a financial institution or other sponsor. The commercial paper issued by the conduit is collateralized by a pool of assets, which may change over the life of the entity. Depending on the type of ABCP program being conducted, the assets collateralizing the ABCP may consist of a wide range of assets including auto loans, commercial loans, trade receivables, credit card receivables, student loans, and other securities. Like other types of commercial paper, the term of ABCP typically is short, and the liabilities are "rolled," or refinanced, at regular intervals. Thus, ABCP conduits generally fund longer-term assets with shorter-term liabilities.

As proposed, this risk retention option in §__.9 of the proposed rules would be available only for short-term ABCP collateralized by receivables or loans and supported

[76] See proposed rules at § __.9.

by a liquidity facility that provides 100 percent liquidity coverage from a regulated institution. This risk retention option would not be available to entities or ABCP programs that operate as securities or arbitrage programs.[77] ABCP conduits that purchase loans or receivables from one originator or multiple originators are commonly referred to as single-seller ABCP programs and multi-seller ABCP programs, respectively. In each of these programs, the sponsor of the ABCP conduit approves the originators whose loans or receivables will collateralize the ABCP issued by the conduit. An "originator-seller" will sell the eligible loans or receivables to an intermediate, bankruptcy remote SPV established by the originator-seller. The credit risk of the receivables transferred to the intermediate SPV then typically is separated into two classes – a senior interest that is purchased by the ABCP conduit and a residual interest that absorbs first losses on the receivables and is retained by the originator-seller. The residual interest retained by the originator-seller typically is sized so that it is sufficiently large to absorb all losses on the underlying receivables.

The ABCP conduit, in turn, issues short-term ABCP that is collateralized by the senior interests purchased from the intermediate SPVs (which itself is supported by the subordination provided by the residual interest retained by the originator-seller). The sponsor of these types of ABCP conduit, which is usually a bank or other regulated financial institution, also typically provides (or arranges for another regulated financial institution to provide) 100 percent liquidity coverage on the ABCP issued by the conduit.

[77] Structured investment vehicles (SIVs) and securities arbitrage ABCP programs both purchase securities (rather than receivables and loans from originators). SIVs typically lack liquidity facilities covering all of these liabilities issued by the SIV, while securities arbitrage ABCP programs typically have such liquidity support.

This liquidity support typically requires the support provider to provide funding to, or purchase assets from, the ABCP conduit in the event that the conduit lacks the funds necessary to repay maturing ABCP issued by the conduit.

The proposal includes several conditions designed to ensure that this option is available only to the type of single-seller or multi-seller ABCP conduits described above. For example, this option is available only with respect to ABCP issued by an "eligible ABCP conduit," as defined by the proposal. The proposal defines an eligible ABCP conduit as an issuing entity that issues ABCP and that meets each of the following criteria.[78] First, the issuing entity must be bankruptcy remote or otherwise isolated for insolvency purposes from the sponsor and any intermediate SPV. Second, the ABS issued by an intermediate SPV to the issuing entity must be collateralized solely by assets originated by a single originator-seller.[79] Third, all the interests issued by an intermediate SPV must be transferred to one or more ABCP conduits or retained by the originator-seller. Fourth, a regulated liquidity provider must have entered into a legally binding commitment to provide 100 percent liquidity coverage (in the form of a lending facility, an asset purchase agreement, a repurchase agreement, or similar arrangement) to all the ABCP issued by the issuing entity by lending to, or purchasing assets from, the

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[78] See proposed rules at §__.2 (definition of "eligible ABCP conduit").

[79] Under the proposal, an originator-seller would mean an entity that creates assets through one or more extensions of credit and sells those assets (and no other assets) to an intermediate SPV, which in turn sells interests collateralized by those assets to one or more ABCP conduits. The proposal defines an intermediate SPV as a special purpose vehicle that is bankruptcy remote or otherwise isolated for insolvency purposes that purchases assets from an originator-seller and that issues interests collateralized by such assets to one or more ABCP conduits. See proposed rules at §__.2 (definitions of "originator-seller" and "intermediate SPV").

issuing entity in the event that funds are required to repay maturing ABCP issued by the issuing entity.[80]

Under the proposed risk retention option applicable to ABCP conduit structures, the sponsor of an eligible ABCP conduit would be permitted to satisfy its base risk retention obligations under the rule if each originator-seller that transfers assets to collateralize the ABCP issued by the conduit retains the same amount and type of credit risk as would be required under the horizontal risk retention option as if the originator-seller was the sponsor of the intermediate SPV. Specifically, the proposal provides that a sponsor of an ABCP securitization transaction would satisfy its base risk retention requirement with respect to the issuance of ABCP by an eligible ABCP conduit if each originator-seller retains an eligible horizontal residual interest in each intermediate SPV established by or on behalf of that originator-seller for purposes of issuing interests to the eligible ABCP conduit. The eligible horizontal residual interest retained by the originator-seller must equal at least five percent of the par value of all interests issued by the intermediate SPV. Accordingly, each originator-seller would be required to retain credit exposure to the receivables sold by that originator-seller to support issuance of the ABCP.

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[80] The proposal defines a regulated liquidity provider as a depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)); a bank holding company (as defined in 12 U.S.C. 1841) or a subsidiary thereof; a savings and loan holding company (as defined in 12 U.S.C. 1467a) provided all or substantially all of the holding company's activities are permissible for a financial holding company under 12 U.S.C. 1843(k) or a subsidiary thereof; or a foreign bank (or a subsidiary thereof) whose home country supervisor (as defined in § 211.21 of the Federal Reserve Board's Regulation K (12 CFR 211.21)) has adopted capital standards consistent with the Capital Accord of the Basel Committee on Banking Supervision, as amended, provided the foreign bank is subject to such standards. See http://www.bis.org/bcbs/index.htm for more information about the Basel Capital Accord.

The eligible horizontal residual interest retained by the originator-seller would be subject to the same terms and conditions as apply under the horizontal risk retention option. Thus, for example, if an originator-seller transfers $100 of receivables to an intermediate SPV, which then issues senior interests and an eligible horizontal residual interest with an aggregate par value of $100, the originator-seller must retain an eligible horizontal residual interest with a par value of $5 or more.[81] Importantly, the originator-seller also would be prohibited from selling, transferring, and hedging the eligible horizontal residual interest that it is required to retain. This option is designed to accommodate the special structure and features of these types of ABCP programs.

Although the proposal would allow the originator-sellers (rather than the sponsor) to retain the required eligible horizontal residual interest, the proposal also imposes certain obligations directly on the sponsor in recognition of the key role the sponsor plays in organizing and operating an eligible ABCP conduit. Most importantly, the proposal provides that the sponsor of an eligible ABCP conduit that issues ABCP in reliance on this option would be responsible for compliance with the requirements of this risk retention option. The proposal also would require that the sponsor maintain policies and procedures to monitor the originator-sellers' compliance with the requirements of the proposal. In the event that the sponsor determines that an originator-seller no longer complies with the requirements of the rule (for example, because the originator-seller has sold the interest it was required to retain), the sponsor would be required to promptly

[81] As noted above, this would be the minimum amount of credit risk that must be retained as part of a securitization transaction.

notify, or cause to be notified, the investors in the securitization transaction of such noncompliance.

In addition, consistent with market practice, the proposal would require that the sponsor:

(i) Establish the eligible ABCP conduit;

(ii) Approve the originator-sellers permitted to sell or transfer assets, indirectly through an intermediate SPV, to the ABCP conduit;

(iii) Establish criteria governing the assets the originator-sellers are permitted to sell or transfer to an intermediate SPV;

(iv) Approve all interests in an intermediate SPV to be purchased by the eligible ABCP conduit;

(v) Administer the ABCP conduit by monitoring the interests acquired by the conduit and the assets collateralizing those interests, arranging for debt placement, compiling monthly reports, and ensuring compliance with the conduit documents and with the conduit's credit and investment policy; and

(vi) Maintain, and adhere to, policies and procedures for ensuring that the requirements of the rule have been met.[82]

The sponsor also would have to provide, or cause to be provided, to potential purchasers a reasonable period of time prior to the sale of any ABCP from the conduit, and to the Commission and its appropriate Federal banking agency, if any, upon request,

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[82] The sponsor of an ABCP conduit satisfies the definition of "sponsor" under the proposed rules. If the conduit does not satisfy the conditions for an "eligible ABCP conduit," the sponsor must retain credit risk in accordance with another risk retention option included in the proposal (unless an exemption for the transaction exists).

the name and form of organization of each originator-seller that will retain (or has retained) an interest in the securitization transaction pursuant to §__.9 of the proposed rules (including a description of the form, amount, and nature of such interest), and of each regulated liquidity provider that provides liquidity support to the eligible ABCP conduit (including a description of the form, amount, and nature of such liquidity coverage).

Section 15G permits the Agencies to allow an originator (rather than a sponsor) to retain the required amount and form of credit risk and to reduce the amount of risk retention required of the sponsor by the amount retained by the originator.[83] In developing the proposed risk retention option for eligible ABCP conduits, the Agencies have considered the factors set forth in section 15G(d)(2) of the Exchange Act.[84] The terms of the proposed option for eligible ABCP conduits include conditions designed to ensure that the interests in the intermediate SPVs sold to an eligible ABCP conduit have low credit risk, and to ensure that originator-sellers have incentives to monitor the quality of the assets that are sold to an intermediate SPV and collateralize the ABCP issued by the conduit. In addition, the proposal is designed to effectuate the risk retention requirements of section 15G of the Exchange Act in a manner that facilitates reasonable

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83 See 15 U.S.C. § 78o-11(1)(c)(G)(iv) and (d) (permitting the Commission and the Federal banking agencies to allow the allocation of risk retention from a sponsor to an originator).

84 15 U.S.C. § 78o-11(d)(2). These factors are whether the assets sold to the securitizer have terms, conditions, and characteristics that reflect low credit risk; whether the form or volume of transactions in securitization markets creates incentives for imprudent origination of the type of loan or asset to be sold to the securitizer; and the potential impact of the risk retention obligations on the access of consumers and businesses to credit on reasonable terms, which may not include the transfer of credit risk to a third party.

access to credit by consumers and businesses through the issuance of ABCP backed by consumer and business receivables. Finally, as noted above, an originator-seller would be subject to the same restrictions on transferring the retained eligible horizontal residual interest to a third party as would apply to sponsors under the rule.

Request for Comment

59. Is the proposed risk retention option for eligible ABCP conduits appropriate?

60(a). Have the Agencies appropriately defined the terms (such as an eligible ABCP conduit, intermediate SPV and originator-seller) that govern use of this option? 60(b). Is the foregoing description of ABCP structures accurate? 60(c) Are there additional ABCP structures that are not easily adaptable to the risk retention options proposed? 60(d). If so, should the proposed ABCP option be revised to include these structures and if so, how?

61. Should the proposed option for securitizations structured using ABCP conduits require financial disclosure regarding the liquidity provider?

62(a). Also, should other entities be permitted to be liquidity providers for purposes of the rule? For example, should the rule permit an insurance company to be an eligible liquidity provider if the company is in the business of providing credit protection (such as a bond insurer or re-insurer) and is subject to supervision by a State insurance regulator or is a foreign insurance company subject to comparable regulation to that imposed by U.S. insurance companies? 62(b). Why or why not?

63. In addition, the Agencies seek confirmation that the terms of this option effectively prevent structures such as SIVs and ABCP programs that operate as arbitrage programs from using this option.

64. Should the rule, as proposed, allow the liquidity provider to be a depository institution holding company or a subsidiary of a depository institution instead of just the depository institution?

65. Are the disclosures proposed sufficient to provide investors with all material information concerning the originator-seller that will retain an interest in the securitization transaction and of each regulated liquidity provider that provides liquidity support to the eligible ABCP conduit, as well as enable investors and the Agencies to monitor whether the sponsor has complied with the rule?

66(a). Should additional disclosures be required? 66(b). If so, what should be required and why? 66(c). For example, should a sponsor be required to disclose the material assumptions and methodology used in determining the aggregate dollar amount of interests issued by each intermediate SPV? 66(d). Would such a disclosure be beneficial to investors? 66(e). In light of the broad range of asset classes that underlie ABCP conduits, would such a disclosure pose any operational or other challenges for sponsors of ABCP conduits?

67(a). Should we, as proposed, require that the ABCP be for a term of 270 days or less? 67(b). Should we allow for a longer term, such as up to one year?

7. Commercial mortgage-backed securities

Section 15G(c)(1)(E) of the Exchange Act provides that, with respect to securitizations involving commercial mortgages, the regulations prescribed by the Agencies may provide for "retention of the first-loss position by a third-party purchaser that specifically negotiates for the purchase of such first loss position, holds adequate financial resources to back losses, provides due diligence on all individual assets in the pool before the issuance of the asset-backed securities, and meets the same standards for risk retention as the Federal banking agencies and the Commission require of the securitizer[.]"[85] In light of this provision, the Agencies are proposing to permit a sponsor of ABS that is collateralized by commercial real estate loans to meet its risk retention requirements if a third-party purchaser acquires an eligible horizontal residual interest in the issuing entity in the same form, amount, and manner as the sponsor would have been required to retain under the horizontal risk retention option and certain additional conditions are met.

The allocation of a first-loss position to a third-party purchaser has been common practice in CMBS transactions for a number of years.[86] The third-party purchaser has been commonly referred to in the CMBS marketplace as a "B-piece buyer"[87] because the CMBS tranche or tranches purchased by this investor were either unrated by the credit rating agencies or assigned a below-investment grade credit rating. Typically a B-piece buyer purchases at a discount to face value the most subordinate tranche in the cash flow waterfall of the CMBS transaction. In order to manage its risk, the B-piece buyer often is involved early in the securitization process and has significant influence over the selection of pool assets. For example, the B-piece buyer often performs "due diligence" on the pool assets, which often means a review of the loans in the pool at the property and loan level. As a result of this review, a B-piece buyer may request that specific loans be removed from the pool prior to securitization.

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[85] 15 U.S.C. § 78o-11(c)(1)(E)(iv).

[86] See, e.g., Board Report.

[87] We note that under the proposal there is no requirement that the tranche or tranches purchased by the third-party purchaser be assigned any particular credit rating.

Additionally, a B-piece buyer is often designated as the "controlling class" under the terms of the pooling and servicing agreement governing the CMBS transaction, and in accordance with its rights as the controlling class, a B-piece buyer often names itself, or an affiliated company, as the "special servicer" in the transaction. Such servicer typically is the servicer authorized to service loans in default or having other non-payment issues. The control of special servicing rights by the B-piece buyer has the potential to create conflicts of interest with the senior certificate holders to the securitization. For example, the control of special servicing rights would allow the B-piece buyer to directly or indirectly manage any loan modifications. While some CMBS transactions required an "operating advisor" to oversee the servicing activities of the special servicer, in many instances this operating advisor works on behalf of the controlling class (i.e., the B-piece buyer unless and until losses reduced its junior tranche to zero). To help better address the potential conflict created by special servicer arrangements involving B-piece buyers, newly issued CMBS for which investors received financing through the Term-Asset Backed Securities Lending Facility ("TALF") were required to have an independent operating advisor that acted on behalf of the investors as a collective whole, had consultative rights over major decisions of the special servicer, and had the ability to recommend replacement of the special servicer.[88] These operating advisor requirements

[88] The TALF was a special lending facility established by the Federal Reserve and the Treasury Department in response to the financial crisis to assist the financial markets in accommodating the credit needs of consumers and businesses of all sizes by facilitating the issuance of ABS collateralized by a variety of consumer and business loans. The TALF also was intended to improve the market conditions for ABS more generally. Additional information concerning the TALF is available on the public websites of the Board (see http://www.federalreserve.gov/monetarypolicy/bst_lendingother.htm) and the Federal Reserve Bank of New York (see http://www.newyorkfed.org/markets/talf.html).

also were coupled with enhanced disclosures to investors regarding major decisions by the B-piece buyer and special servicer. Aspects of these TALF requirements have been incorporated into recent CMBS transactions undertaken after the closing of the TALF to new financings.

In light of the specific provisions of Section 15G(c)(1)(E) and the historical market practice of third-party purchasers acquiring first-loss positions in CMBS transactions, the Agencies' proposal would allow a sponsor to meet its risk retention requirements under the rule if a third-party purchaser retains the necessary exposure to the credit risk of the underlying assets provided six conditions are met. These conditions are designed to help ensure that the form, amount, and manner of the third-party purchaser's risk retention are consistent with the purposes of section 15G of the Exchange Act. This option would be available only for securitization transactions where commercial real estate loans constitute at least 95 percent of the unpaid principal balance of the assets being securitized.[89]

The first condition requires that the third-party purchaser retain an eligible horizontal residual interest in the securitization in the same form, amount, and manner as would be required of the sponsor under the horizontal risk retention option (proposed

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[89] See proposed rules at §__.10(a). "Commercial real estate loan" is defined in §__.16 of the proposed rules to mean a loan secured by a property with five or more single family units, or by nonfarm nonresidential real property, the primary source (fifty (50) percent or more) of repayment for which is expected to be derived from the proceeds of the sale, refinancing, or permanent financing of the property; or rental income associated with the property other than rental income derived from any affiliate of the borrower. A commercial real estate loan does not include a land development and construction loan (including 1- to 4-family residential or commercial construction loans); any other land loan; a loan to a real estate investment trust (REIT); or an unsecured loan to a developer.

§ _____.5).[90] Accordingly, the interest acquired by the third-party purchaser must be the most junior interest in the issuing entity, and must be subject to the same limits on payments as would apply if the eligible horizontal residual interest were held by the sponsor pursuant to the horizontal risk retention option.

The second condition would require that the third-party purchaser pay for the first-loss subordinated interest in cash at the closing of the securitization without financing being provided, directly or indirectly, from any other person that is a party to the securitization transaction (including, but not limited to, the sponsor, depositor, or an unaffiliated servicer), other than a person that is a party solely by reason of being an investor.[91] This would prohibit the third-party purchaser or an affiliate of the third-party purchase from obtaining financing from any such person as well as from any affiliate of any such person. These requirements should help ensure that the third-party purchaser has sufficient financial resources to fund the acquisition of the first-loss subordinated interest and absorb losses on the underlying assets to which it would be exposed through this interest.[92]

The third condition relates to the third-party purchaser's review of the assets collateralizing the ABS. This proposed condition would require that the third-party purchaser perform a review of the credit risk of each asset in the pool prior to the sale of the asset-backed securities. This review must include, at a minimum, a review of the

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[90] See proposed rules at § __.10.

[91] See proposed rules at § __.10.

[92] This requirement is consistent with section 15G(b)(1)(E)(ii) of the Exchange Act, which provides that the Agencies may consider whether a third-party purchaser of CMBS "holds adequate financial resources to back losses."

underwriting standards, collateral, and expected cash flows of each commercial loan in the pool.

The fourth condition is intended to address the potential conflicts of interest that can arise when a third-party purchaser serves as the "controlling class" of a CMBS transaction. This condition would prohibit a third-party purchaser from (i) being affiliated with any other party to the securitization transaction (other than investors); or (ii) having control rights in the securitization (including, but not limited to acting as servicer or special servicer) that are not collectively shared by all other investors in the securitization. The proposed prohibition of control rights related to servicing, would be subject to an exception, however, if the underlying securitization transaction documents provide for the appointment of an independent operating advisor (Operating Advisor) with certain powers and responsibilities.[93] Under the proposal, an "Operating Advisor" would be defined as a party that (i) is not affiliated with any other party to the securitization, (ii) does not directly or indirectly have any financial interest in the securitization other than in fees from its role as Operating Advisor, and (iii) is required to act in the best interest of, and for the benefit of, investors as a collective whole.

The Agencies believe that the introduction of an independent Operating Advisor would minimize the ability of third-party purchasers to manipulate cash flows through special servicing. In approving loans for inclusion in the securitization, the third-party

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[93] See proposed rules at §__.10(a)(4)(i). The proposal also includes a de minimis exception to the general prohibition on affiliation with other parties to the securitization transaction. Under this de minimis exception, the third-party purchaser would be permitted to be affiliated with one or more originators of the securitized assets so long as the assets contributed by such originator(s) collectively comprise less than 10 percent of the assets in the pool (as measured by dollar volume). See proposed rules at §__.10(a)(4)(ii).

purchaser will be mindful of the limits on its ability to offset the consequences of poor underwriting through servicing tactics if a loan becomes troubled, thereby providing stronger incentive for the third-party purchaser to be diligent in assessing credit quality of the pool assets at the time of securitization. For these types of securitization transactions, the third-party purchaser's review of each loan can serve as an effective check on the underwriting quality and credit risk of the underlying loans and the reliability of key information utilized.

Further, in order for a third-party purchaser to have servicing rights in connection with the securitization transaction, the securitization transaction documents must require that the Operating Advisor have certain powers and responsibilities in order to ensure that the Operating Advisor can effectively fulfill its advisory role in the transaction.[94] For example, as proposed, the transaction documents must require that, if the third-party purchaser or an affiliate acts as servicer, the servicer consult with the Operating Advisor in connection with, and prior to, any major decision in connection with the servicing of the securitized assets. Major decisions would include, without limitation, any material modification of, or waiver with respect to, any provision of a loan agreement, any foreclosure upon or comparable conversion of the ownership of a property, and any acquisition of a property.

The securitization transaction documents must also provide that the Operating Advisor is responsible for reviewing the actions of any servicer that is, or is, affiliated with the third-party purchaser and for issuing a report to investors and the issuing entity, on a periodic basis, concerning whether the Operating Advisor believes, in its sole

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[94] See proposed rules at §__.10(a)(4)(B)-(E).

discretion exercised in good faith, the servicer is in compliance with any standards required of the servicer as provided in the applicable transaction documents, and if not, the standard(s) with which the servicer is out of compliance. In addition, the securitization transaction documents must also provide that the Operating Advisor has the authority to recommend that a servicer that is, or is affiliated with, the third-party purchaser be replaced by a successor servicer if the Operating Advisor determines, in its sole discretion exercised in good faith, that the servicer has failed to comply with any standard required of the servicer as provided in the applicable transaction documents and that such replacement would be in the best interest of the investors as a collective whole. The relevant transaction documents must provide that, if such a recommendation is made, the servicer that is, or affiliated with, the third-party purchaser must be replaced unless a majority of each class of certificate holders eligible to vote on the matter votes to retain the servicer.

Consistent with other disclosure requirements under the proposed rules, the fifth proposed condition requires that the sponsor provide, or cause to be provided, potential purchasers certain information concerning the third-party purchaser and other information concerning the transaction. Specifically, the proposal would require that a sponsor disclose to potential investors a reasonable time before the sale of asset-backed securities and, upon request, to the Commission and its appropriate Federal banking agency (if any) the name and form of organization of the third-party purchaser, a description of the third-party purchaser's experience in investing in CMBS, and any other information regarding the third-party purchaser or the third-party purchaser's retention of the eligible horizontal residual interest that is material to investors in light of the circumstances of the particular securitization transaction.

Additionally, a sponsor would be required to disclose the amount of the eligible horizontal residual interest that the third-party purchaser will retain (or has retained) in the transaction (expressed as a percentage of ABS interests in the issuing entity and as a dollar amount); the purchase price paid for such interest; the material terms of such interest; and the amount of the interest that the sponsor would have been required to retain if the sponsor had retained an interest in the transaction pursuant to the horizontal menu option. The material assumptions and methodology used in determining the aggregate amount of ABS interests of the issuing entity, including any estimated cash flows and the discount rate used, also must be included in the disclosure. The proposed rules would require that the sponsor provide, or cause to be provided, to potential investors the representations and warranties concerning the securitized assets, the schedule of any securitized assets that are determined not to comply with such representations and warranties, and what factors were used to make the determination that a securitized asset should be included in the pool notwithstanding that it did not comply with such representations and warranties, such as compensating factors or a determination that the exceptions(s) were not material.

Finally, the sixth condition would require that any third-party purchaser acquiring an eligible horizontal residual interest under this option comply with the hedging, transfer and other restrictions applicable to such interest under the proposed rules if the third-party purchaser was a sponsor who had acquired the interest under the horizontal risk retention option.

Although the third-party purchaser may retain the credit risk required under § __.3 of the proposed rules, the proposal provides that the sponsor remains responsible for compliance with the requirements described above. Therefore, consistent with the menu option available to eligible ABCP conduits, the proposal would require that the sponsor maintain and adhere to policies and procedures to monitor the third-party purchaser's compliance with these requirements. In the event that the sponsor determines that the third-party purchaser no longer complies with the requirements of the rule (for example, because the third-party purchaser has sold the interest it was required to retain), the sponsor must promptly notify the investors in the securitization transaction of such noncompliance.

Request for Comment

68(a). Should the rules allow a third-party purchaser to retain the required amount of risk in a CMBS transaction as described above? 68(b). Why or why not?

69(a). Should a third-party purchaser option be available to other asset classes besides CMBS? Would expanding this option to other asset classes fulfill the purposes of section 15G? 69(b). If so, would any adjustments or requirements be necessary?

70. Should the use of this option be conditioned, as proposed, on a requirement that the third-party purchaser separately examine the assets in the pool and/or not sell or hedge the interest it is required to retain?

71(a). Should the use of this option be conditioned, as proposed, on the requirement that the sponsor disclose the actual purchase price paid by the third-party purchaser for the eligible horizontal residual interest? 71(b). Why or why not?

72. Is any disclosure concerning the financial resources of the third-party purchaser necessary in light of the requirement that the third-party purchaser fund the acquisition of the eligible horizontal residual interest in cash without direct or indirect financing from a party to the transaction?

73(a). Should the rule specify the particular types of information about a third-party purchaser that should be disclosed, rather than requiring disclosure of any other information regarding the third-party purchaser that is material to investors in light of the circumstances of the particular securitization transaction? 73(b). Should the specific types of information about a third-party purchaser be in addition to any other information regarding the third-party purchaser that is material to investors in light of the circumstances of the particular securitization transaction?

74. Are the conditions relating to servicing, including those related to an Operating Advisor, appropriate or should they be modified or supplemented?

75(a). Should the Agencies require any other disclosure relating to representations and warranties concerning the assets for CMBS?

76(a). We are aware of at least one industry group developing model representations and warranties for CMBS.[95] Should the rule require that a blackline of the representations and warranties for the securitization transaction against an industry-accepted standard for model representations and warranties be provided to investors at a reasonable time prior to sale? 76(b). Would this provide more information regarding the

[95] See, e.g., comment letter to the Commission from CRE Finance Council dated January 19, 2011, available at http://www.sec.gov/comments/df-title-ix/asset-backed-securities/assetbackedsecurities-37.pdf.

adequacy of the representation and warranties being provided? 76(c). Would this be a costly requirement? 76(d). Could investors easily create their own blacklines if needed?

77. Are the disclosures proposed sufficient to provide investors with all material information concerning the third-party purchaser's retained interest in the securitization transaction, as well as to enable investors and the Agencies to monitor whether the sponsor has complied with the rule?

78(a). Should additional disclosures be required? 78(b). If so, what should be required and why?

8. Treatment of government-sponsored enterprises

Section ___.11 of the proposed rules would govern the credit risk retention requirements for the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (jointly, the "Enterprises") while operating under the conservatorship or receivership of FHFA, as well as for any limited-life regulated entity succeeding to the charter of either Fannie Mae or Freddie Mac pursuant to section 1367 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (Safety and Soundness Act).[96] The primary business of the Enterprises under their respective charter acts is to pool conventional mortgage loans and to issue securities backed by these mortgages that are fully guaranteed as to the timely payment of principal and interest by the issuing Enterprise.[97] Because of these activities, Fannie Mae or Freddie Mac (or a successor limited-life regulated entity) would be the sponsor of the asset-backed securities that it issues for purposes of section 15G.

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[96] 12 U.S.C. § 4617.

[97] See 12 U.S.C. § 1451, et seq. (Freddie Mac); 12 U.S.C. § 1716, et seq. (Fannie Mae).

In considering how to address in the proposal the risk retention requirements of section 15G with respect to the mortgage-backed securities issued, and fully guaranteed as to timely payment of principal and interest, by the Enterprises or a successor limited-life regulated entity, the Agencies considered several factors. Because Fannie Mae and Freddie Mac fully guarantee the timely payment of principal and interest on the mortgage-backed securities they issue, the Enterprises are exposed to the entire credit risk of the mortgages that collateralize those securities.[98]

Both Fannie Mae and Freddie Mac have been operating under the conservatorship of FHFA since September 6, 2008. As conservator, FHFA has assumed all powers formerly held by each Enterprise's officers, directors, and shareholders. In addition, FHFA, as conservator, is authorized to take such actions as may be necessary to restore each Enterprise to a sound and solvent condition and that are appropriate to preserve and conserve the assets and property of each Enterprise.[99] The primary goals of the conservatorships are to help restore confidence in the Enterprises, enhance their capacity to fulfill their mission, mitigate the systemic risk that contributed directly to instability in financial markets, and maintain the Enterprises' secondary mortgage market role until their future is determined through legislation. To these ends, FHFA's conservatorship of the Enterprises is directed toward minimizing losses, limiting risk exposure, and ensuring that the Enterprises price their services to adequately address their costs and risk. Any limited-life regulated entity established by FHFA to succeed to the charter of an

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[98] The charters of Fannie Mae and Freddie Mac also place limitations on the types of mortgages that the Enterprises may guarantee and securitize.

[99] See 12 U.S.C. § 4617(b)(2)(D).

Enterprise also would operate under the direction and control of FHFA, acting as receiver of the related Enterprise.[100]

Concurrently with being placed in conservatorship under section 1367 of the Safety and Soundness Act, each Enterprise entered into a Senior Preferred Stock Purchase Agreement (PSPA) with the United States Department of the Treasury (Treasury). Under each PSPA, Treasury purchased senior preferred stock of each Enterprise. In addition, if FHFA determines that the Enterprise's liabilities have exceeded its assets under generally accepted accounting principles (GAAP), Treasury will contribute cash capital to that Enterprise in an amount equal to the difference between its liabilities and assets. In exchange for this cash contribution, the liquidation preference of the senior preferred stock purchased from each Enterprise under the respective PSPA increases in an equivalent amount. The senior preferred stock of each Enterprise purchased by Treasury is senior to all other preferred stock, common stock or other capital stock issued by the Enterprise, and dividends on the aggregate liquidation preference of the senior preferred stock purchased by Treasury are payable at a rate of 10 percent per annum.[101] Under each PSPA, Treasury's commitment to each Enterprise is the greater of (1) $200 billion, or (2) $200 billion plus the cumulative amount of the Enterprise's net worth deficit as of the end of any calendar quarter in 2010, 2011 and

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[100] See 12 U.S.C. § 4617(i). The affairs of a limited-life regulated entity must be wound up not later than two years after its establishment, subject to the potential for a maximum of three one-year extensions at the discretion of the Director of FHFA.

[101] Under the PSPAs, the rate rises to 12 percent per annum if the dividends are not paid in cash.

2012, less any positive net worth as of December 31, 2012.[102] Accordingly, the PSPAs provide support to the relevant Enterprise should the Enterprise have a net worth deficit as a result of the Enterprise's guaranty of timely payment on the asset-backed securities it issues. By their terms, the PSPA with an Enterprise may not be assigned or transferred, or inure to the benefit of, any limited-life regulated entity established with respect to the Enterprise without the prior written consent of Treasury.

In light of the foregoing, § ___.11 of the proposed rules provides that the guaranty provided by an Enterprise while operating under the conservatorship or receivership of FHFA with capital support from the United States will satisfy the risk retention requirements of the Enterprise under section 15G of the Exchange Act with respect to the mortgage-backed securities issued by the Enterprise. Similarly, an equivalent guaranty provided by a limited-life regulated entity that has succeeded to the charter of an Enterprise, and that is operating under the direction and control of FHFA under section 1367(i) of the Safety and Soundness Act, will satisfy the risk retention requirements, provided that the entity is operating with capital support from the United States. If either Enterprise or a successor limited-life regulated entity were to begin to operate other than as provided in the proposed rules, that Enterprise or entity would no longer be able to avail itself of the credit risk retention option set forth in § ___.11.

For similar reasons, the proposed rules provide that the premium capture cash reserve account requirements in § ___.12, as well as the hedging and financing prohibitions in

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[102] The PSPAs also provide for the retained portfolios of each Enterprise to be reduced over time.

§ ___.14(b),(c), and (d), of the proposed rules shall not apply to an Enterprise while operating under the conservatorship or receivership of FHFA with capital support from the United States, or to a limited-life regulated entity that has succeeded to the charter of an Enterprise and that is operating under the direction and control of FHFA with capital support from the United States. In the past, the Enterprises have sometimes acquired pool insurance to cover a percentage of losses on the mortgage loans comprising the pool.[103] Because § ___.11 requires each Enterprise, while in conservatorship or receivership, to hold 100 percent of the credit risk on MBS that it issues, the prohibition on hedging related to the credit risk that the retaining sponsor is required to retain would limit the ability of the Enterprises to require such pool insurance in the future. Because the exception would continue only so long as the relevant Enterprise operates under the control of FHFA and with capital support from the United States, the proposed exception from these restrictions should be consistent with the maintenance of quality underwriting standards, in the public interest, and consistent with the protection of investors.

A sponsor utilizing this section shall provide to investors, in written form under the caption "Credit Risk Retention" and, upon request, to FHFA and the Commission, a description of the manner in which it has met the credit risk retention requirement of this part.

The Agencies recognize both the need for, and importance of, reform of the Enterprises. In recent months, the Administration and Congress have been considering a variety of proposals to reform the housing finance system and the Enterprises. The

[103] Typically, insurers would pay the first losses on a pool of loans, up to one or two percent of the aggregate unpaid principal balance of the pool.

Agencies expect to revisit and, if appropriate modify § __.11 of the proposed rules after the future of the Enterprises and of the statutory and regulatory framework for the Enterprises becomes clearer.

Request for comment

79. Is our proposal regarding the treatment of the Enterprises appropriate?

80. Would applying the hedging prohibition to all of the credit risk that the Enterprises are required to retain when using § ___.11 to satisfy the risk retention requirements be an unduly burdensome result for the Enterprises?

81(a). Instead of the broad exception from the hedging prohibition for the Enterprises, when satisfying the risk retention requirements pursuant to § ___.11, should the rules prohibit an Enterprise from hedging five percent of the total credit risk in any securitization transaction where the Enterprise acts as a sponsor (thus ensuring the Enterprise retains at least that amount of exposure to the credit risk of the assets)? 81(b). Would this be consistent with statutory intent? 81(c). Would that be feasible for the Enterprises to monitor?

9. Premium Capture Cash Reserve Account

In many securitization transactions, particularly those involving residential and commercial mortgages, conducted prior to the financial crisis, sponsors sold premium or interest-only tranches in the issuing entity to investors, as well as more traditional obligations that paid both principal and interest received on the underlying assets. By selling premium or interest-only tranches, sponsors could thereby monetize at the inception of a securitization transaction the "excess spread" that was expected to be generated by the securitized assets over time. By monetizing excess spread before the performance of the securitized assets could be observed and unexpected losses realized, sponsors were able to reduce the impact of any economic interest they may have retained in the outcome of the transaction and in the credit quality of the assets they securitized. This created incentives to maximize securitization scale and complexity, and encouraged aggressive underwriting.

In order to achieve the goals of risk retention, the Agencies propose to adjust the required amount of risk retention to account for any excess spread that is monetized at the closing of a securitization transaction. Otherwise, a sponsor could effectively negate or reduce the economic exposure it is required to retain under the proposed rules. Furthermore, prohibiting sponsors from receiving compensation in advance for excess spread income expected to be generated by securitized assets over time should better align the interests of sponsors and investors and promote more robust monitoring by the sponsor of the credit risk of securitized assets, thereby encouraging the use of sound underwriting in connection with securitized loans. It also should promote simpler and more coherent securitization structures as sponsors would receive excess spread over time and would not be able to reduce the economic exposure they are required to retain.

Accordingly, as proposed, if a sponsor structures a securitization to monetize excess spread on the underlying assets–which is typically effected through the sale of interest-only tranches or premium bonds–the proposed rule would "capture" the premium or purchase price received on the sale of the tranches that monetize the excess spread and require that the sponsor place such amounts into a separate "premium capture cash reserve account."[104] The amount placed into the premium capture cash reserve account

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[104] See proposed rules at § ___.12.

would be separate from and in addition to the sponsor's base risk retention requirement under the proposal's menu of options, and would be used to cover losses on the underlying assets before such losses were allocated to any other interest or account. As a likely consequence to this proposed requirements, the Agencies expect that few, if any, securitizations would be structured to monetize excess spread at closing and, thus, require the establishment of a premium capture cash reserve account, which should provide the benefits described above.

Specifically, the proposal would require that a sponsor retaining credit risk under the vertical, horizontal, L-shaped, or revolving asset master trust options of the proposed rules establish and fund (in cash) at closing a premium capture cash reserve account in an amount equal to the difference (if a positive amount) between (i) the gross proceeds received by the issuing entity from the sale of ABS interests in the issuing entity to persons other than the sponsor (net of closing costs paid by a sponsor or the issuing entity to unaffiliated parties); and (ii) 95 percent of the par value of all ABS interests in the issuing entity issued as part of the transaction. The 95 percent of par value amount is designed to take into account the five percent interest that the sponsor is required to retain in the issuing entity under each of these options.

If the sponsor will retain (or caused to be retained) credit risk under the representative sample, ABCP, or CMBS third-party purchaser options of the proposed rules, the sponsor would have to fund in cash at closing a premium capture cash reserve account in an amount equal to the difference (if a positive amount) between (i) the gross proceeds received by the issuing entity from the sale of ABS interests to persons other than the sponsor (net of the closing costs described above), and (ii) 100 percent of the par value of the ABS interests in the issuing entity issued as part of the transaction. In these cases, the proposal uses 100 percent (rather than 95 percent) of the par value of the ABS interests issued because the relevant menu options do not require that the sponsor itself retain any of the ABS interests issued in the transaction and, accordingly, potentially all of such interests could be sold to third parties.

Under the proposed rules, a premium capture cash reserve account would have to be established and funded whenever a positive amount resulted from the relevant calculation described in the preceding paragraphs. These calculations are designed to capture the amount of excess spread that a sponsor may seek to immediately monetize at closing such as through the issuance of an interest-only tranche (which may have a nominal value assigned to it, but does not have a par value) or premium bonds that are sold for amounts in excess of their par value. On the other hand, the proposal would not require a sponsor to establish and fund a premium capture cash reserve account if the sponsor does not structure the securitization to immediately monetize excess spread, thus resulting in no "premium" that would be captured by the calculations described above. Accordingly, existing types of securitization structures that do not monetize excess spread at closing would not trigger establishment of a premium capture reserve account. Going forward, sponsors would have the ability to structure their securitization transactions in a manner that does not monetize excess spread at closing and would not require the establishment of such a premium capture cash reserve account.

The proposed rules include a number of conditions and limitations on a premium capture cash reserve account. Specifically, the proposed rules would require that the premium capture cash reserve account be held by the trustee, or person performing functions similar to a trustee, in the name and for the benefit of the issuing entity. In addition, until all ABS interests in the issuing entity (including junior or residual interests) are paid in full or the issuing entity is dissolved, amounts in the account would be required to be released to satisfy payments on ABS interests in the issuing entity (in order of the securitization transaction's priority of payments) on any payment date where the issuing entity has insufficient funds to make such payments. The proposal specifies that, the determination of whether insufficient funds are available must be made <u>prior</u> to the allocation of any losses to (i) any eligible horizontal residual interest held under the horizontal, L-shaped, ABCP, or CMBS third-party purchaser risk retention options; or (ii) the class of ABS interests in the issuing entity that is allocated losses before other classes if no eligible horizontal residual interest in the issuing entity is held under such options (or if the contractual terms of the securitization transaction do not provide for the allocation of losses by class, the class of ABS interests that has the most subordinate claim to payment of principal or interest by the issuing entity). Thus, amounts in a premium capture reserve account would be used to cover losses on the underlying assets first before any other interest in or account of the issuing entity, including an eligible horizontal residual interest or a horizontal cash reserve account.[105]

In order to prevent a sponsor from circumventing the premium capture requirements of the proposal by taking back at closing, and then reselling, additional

[105] Until needed to cover losses, amounts in a premium capture cash reserve account may be invested in U.S. Treasury securities with remaining maturities of 1 year or less and in fully-insured deposits at one or more insured depository institutions. Interest received on such investments could be released from the account to any person (including the sponsor), but the principal amount invested must remain in the account and available to absorb losses.

ABS interests (thereby reducing the gross proceeds received at closing from the sale of interests to third parties), the proposal includes a special anti-evasion provision. Under this provision, the retaining sponsor would need to add to the "gross proceeds" amount that is used to calculate the amount (if any) that must be placed in the premium capture cash reserve account an amount equal to the par value of any ABS interest (or the fair value of the ABS interest if it does not have a par value) in the issuing entity that is directly or indirectly transferred to the sponsor in connection with the closing of the securitization transaction and that (i) the sponsor does not intend to hold to maturity; or (ii) represents a contractual right to receive some or all of the interest, and no more than a minimal amount of principal payments received by the issuing entity, and that has a priority of payment of interest (or principal, if any) senior to the most subordinated class of interests in the issuing entity. The condition in (i) above is designed to capture proceeds from those interests that the sponsor retains at closing, but expects to sell to third parties after closing. ABS interests retained and expected to be held to maturity by the sponsor increase the sponsor's exposure to the credit risk of the underlying assets, thus mitigating the concerns of a sponsor trying to evade the risk retention requirements.

A sponsor could, however, seek to achieve the same economic benefits that could be achieved from the sale of an interest-only tranche by retaining an interest-only tranche at or near the top of the waterfall that diverts to the sponsor excess spread on the underlying assets before other interests are paid. For this reason, the proposal requires that the value of any interest-only tranche that the sponsor retains at closing be included in the calculation of the premium capture reserve account (regardless of whether the sponsor intends to hold it to maturity) if such tranche has priority of payment senior to the most subordinated class of interests in the issuing entity.[106]

Sponsors required to fund a premium capture cash reserve account under the proposed rules would be required to provide potential investors before the sale of asset-backed securities as part of the securitization transaction and, upon request, the Commission and its appropriate Federal banking agency (if any) disclosures describing the dollar amount the sponsor was required to place in the account and the actual amount the sponsor will deposit (or has deposited) in the account at closing. The sponsor would also be required to disclose the material assumptions and methodology used in (i) determining the fair value of any ABS interest in the issuing entity that does not have a par value (and that was used in calculating the amount required for the premium capture cash reserve account) and is subject to the anti-evasion provisions described above; and (ii) the aggregate amount of ABS interests in the issuing entity, including those pertaining to any estimated cash flows and the discount rate used.

Request for Comment

82. Do you believe the premium capture cash reserve account will be an effective mechanism at capturing the monetization of excess spread, promoting sponsor monitoring of credit quality, and promoting the sound underwriting of securitized assets?

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[106] To avoid double counting, the calculation would not include any interest-only tranche required to be retained by a sponsor using the vertical or L-shaped options to meet its risk retention requirement. Also, because an eligible horizontal residual interest, by definition, must have the most subordinated claim to payments of both principal and interest, a sponsor selecting this option of risk retention would be required to include the value of any excess spread tranche retained by the sponsor in its calculation of gross proceeds received by the issuing entity.

83. The Agencies seek input on alternative methods for removing incentives to monetize excess spread and whether the proposed premium capture reserve account would have any adverse effects on securitizations that are inconsistent with the purposes of section 15G. For example, is the method of calculating the premium capture cash reserve account appropriate or are there alternative methodologies that would better achieve the purpose of the account?

84. Should amounts from the premium capture reserve account be used only for amounts due to the senior-most class of ABS interests?

85(a). Alternatively, are the conditions imposed on the premium capture cash reserve account more than what is needed to achieve the objectives of the account? 85(b). If so, how?

C. Allocation to the originator

As a general matter, the proposed rules would provide that the sponsor of a securitization transaction is solely responsible for complying with the risk retention requirements established under section 15G of the Exchange Act. However, subject to a number of considerations, section 15G authorizes the Agencies to allow a sponsor to allocate at least a portion of the credit risk it is required to retain to the originator(s) of securitized assets.[107] Accordingly, subject to conditions and restrictions discussed below, § __.13 of the proposed rules permits a sponsor to reduce its required risk retention

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[107] As discussed above, 15 U.S.C. § 78o-11(a)(4) defines the term "originator" as a person who, through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security; and who sells an asset directly or indirectly to a securitizer (i.e., a sponsor or depositor). Because this definition refers only to the person that "creates" a loan or other receivable, only the original creditor of a loan or receivable—and not a subsequent purchaser or transferee—would be deemed to be the "originator" for purposes of the proposed rules. See 15 U.S.C. § 78o-11(c)(1)(G)(iv); (d).

obligations in a securitization transaction by the portion of risk retention obligations assumed by the originator(s) of the securitized assets.

When determining how to allocate the risk retention requirements, the Agencies are directed to consider whether the assets sold to the sponsor have terms, conditions, and characteristics that reflect low credit risk; whether the form or volume of the transactions in securitization markets creates incentives for imprudent origination of the type of loan or asset to be sold to the sponsor; and the potential impact of the risk retention obligations on the access of consumers and businesses to credit on reasonable terms, which may not include the transfer of credit risk to a third party.[108]

The Agencies are proposing a framework that would permit a sponsor of a securitization to allocate a portion of its risk retention obligation to an originator that contributes a significant amount of assets to the underlying asset pool. The Agencies have endeavored to create appropriate incentives for both the securitization sponsor and the originator(s) to maintain and monitor appropriate underwriting standards, respectively, without creating undue complexity, which potentially could mislead investors and confound supervisory efforts to monitor compliance. Importantly, the proposal does not mandate allocation to an originator. Therefore, it does not raise the types of concerns about credit availability that might arise if certain originators, such as mortgage brokers or small community banks (that may experience difficulty obtaining

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[108] 15 U.S.C. § 78o-11(d)(2). The Agencies note that section 15G(d) appears to contain an erroneous cross-reference. Specifically, the reference at the beginning of section 15G(d) to "subsection (c)(1)(E)(iv)" is read to mean "subsection (c)(1)(G)(iv)", as the former subsection does not pertain to allocation, while the latter is the subsection that permits the Agencies to provide for the allocation of risk retention obligations between a securitizer and an originator in the case of a securitizer that purchases assets from an originator.

funding to retain risk positions), were required to do so. Mandatory allocation of risk retention to the originator of the securitized assets also could pose significant operational and compliance problems, as a loan may be sold or transferred several times between origination and securitization and, accordingly, an originator may not know when a loan it has originated is included in a securitization transaction.

The proposed rules would permit a securitization sponsor that satisfies its base risk retention obligation either under the vertical risk retention option as set forth in §__.4 or under the horizontal risk retention option through the acquisition of an eligible horizontal interest as set forth in §__.5, to allocate a portion of its risk retention obligation under such option to any originator of the underlying assets that contributed at least 20 percent of the underlying assets in the pool. The amount of the retention interest held by each originator that is allocated credit risk in accordance with the proposal must be at least 20 percent, but could not exceed the percentage of the securitized assets it originated. The originator would also have to hold its allocated share of the risk retention obligation in the same manner as would have been required of the sponsor and subject to the same restrictions on transferring, hedging, and financing the retained interest that would apply to the sponsor. Thus, for example, if the sponsor satisfies its risk retention requirements by acquiring an eligible horizontal residual interest under the horizontal risk retention option, an originator allocated risk under § __.13 of the proposal would have to acquire a portion of that horizontal first-loss interest, in an amount not exceeding the percentage of pool assets created by the originator. The sponsor's risk retention requirements would be reduced by the amount allocated to the originator.

The Agencies believe this approach is a relatively straightforward way to allow both the sponsor and the originator to retain credit risk in securitized assets, on a basis that should reduce the potential for confusion by investors in asset-backed securities.

By limiting this option to originators that have originated at least 20 percent of the asset pool, the Agencies have sought to ensure that the originator retains risk in an amount significant enough to function as an actual incentive for the originator to monitor the quality of all the assets being securitized (and to which it would retain some credit risk exposure). In addition, by restricting originators to holding no more than their proportional share of the risk retention obligation, the proposal seeks to prevent sponsors from circumventing the purpose of the risk retention obligation by transferring an outsized portion of the obligation to an originator that may be seeking to acquire a speculative investment. These requirements should also reduce the proposal's potential complexity and facilitate investor and regulatory monitoring.

Request for Comment

86(a). Should the proposed rules permit allocation to originators where the sponsor is using other menu options, such as the L-shaped risk retention option in § __6. of the proposed rules, and if so, under what specific conditions and requirements? 86(b). In what cases is it likely that this alternative approach actually would be used? 86(c). What are the specific benefits of an alternative approach, and do they outweigh concerns regarding complexity?

87. Should the rule permit allocation to originators if the sponsor elects the horizontal cash reserve account option in proposed § __.5(b)?

88(a). Should the proposed rules permit allocation of risk to originators that have originated less than 20 percent of the asset pool? 88(b). Alternately, is the minimum 20 percent threshold sufficient to ensure that an originator allocated risk has an incentive to monitor the quality of the entire collateral pool?

89(a). Are there alternative mechanisms for allocating risk to an originator that should be permitted by the Agencies? For example, should the rules permit or require that an originator that is allocated risk retention by a sponsor retain exposure only to the assets that the originator itself originates? 89(b). If so, how might such an allocation mechanism feasibly be structured, incorporated into the rule, and monitored by investors and supervisors?

90. Should the rules permit sponsors to allocate risk to a third party, and if so, how to ensure that incentives between the sponsor and investors are aligned in a manner that promotes quality underwriting standards?

91. Are the proposed disclosures sufficient to provide investors with all material information concerning the originator's retained interest in a securitization transaction, as well as to enable investors to monitor the originator(s) and the Agencies to assess the sponsor's compliance with the rule?

92(a). Should additional disclosures be required? 92(b). If so, what should be required and why?

93(a). As proposed, the retaining sponsor is responsible for compliance with the rule and must maintain and adhere to policies and procedures reasonably designed to monitor compliance by each originator retaining credit risk, including the anti-hedging restrictions. 93(b). What are the practical implications if the originator fails to comply?

94(a). To help ensure that the originator has sufficient incentive to retain its interest in accordance with the rule, should the rule require that a sponsor obtain a contractual commitment from the originator to retain the interest in accordance with the rule? 94(b). If so, how should the Agencies implement this requirement?

95. Are there other methods that could be implemented to help ensure that a sponsor satisfies its obligations under the rule?

D. Hedging, transfer and financing restrictions

Section 15G(a)(1)(A) provides that the risk retention regulations prescribed shall "prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain with respect to an asset."[109] Consistent with this statutory directive, the proposed rules would prohibit a sponsor from transferring any interest or assets that it is required to retain under the rule to any person other than an affiliate whose financial statements are consolidated with those of the sponsor (a consolidated affiliate). The rule permits a transfer to one or more consolidated affiliates because the required risk exposure would remain within the consolidated organization and, thus, would not reduce the organization's financial exposure to the credit risk of the securitized assets.

The proposal also would prohibit a sponsor or any consolidated affiliate from hedging the credit risk the sponsor is required to retain under the rule. The proposal extends the hedging prohibition to a sponsor's consolidated affiliates because the rule would allow a sponsor to transfer the risk it is required to retain to a consolidated affiliate. Moreover, even absent such a transfer, if a consolidated affiliate was permitted

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[109] 15 U.S.C. § 78o-11(a)(1)(A).

to hedge the risks required to be retained by a sponsor, the net effect of the hedge on the organization controlling the sponsor would offset the credit risk required to be retained and defeat the purposes of section 15G.

The proposal prohibits a sponsor and its consolidated affiliates from purchasing or selling a security or other financial instrument, or entering into an agreement (including an insurance contract), derivative or other position, with any other person if: (i) payments on the security or other financial instrument or under the agreement, derivative, or position are materially related to the credit risk of one or more particular ABS interests, assets, or securitized assets that the retaining sponsor is required to retain, or one or more of the particular securitized assets that collateralize the asset-backed securities; and (ii) the security, instrument, agreement, derivative, or position in any way reduces or limits the financial exposure of the sponsor to the credit risk of one or more of the particular ABS interests, assets, or securitized assets, or one or more of the particular securitized assets that collateralize the asset-backed securities. The statutory hedging prohibition is focused on the credit risk associated with the interest or assets that a sponsor is required to retain, which itself is dependent on the credit risk of the particular securitized assets that underlie the ABS interests. Therefore, hedge positions that are not materially related to the credit risk of the particular ABS interests or exposures required to be retained by the sponsor or its affiliate would not be prohibited under the proposal. Such positions would include hedges related to overall market movements, such as movements of market interest rates (but not the specific interest rate risk, also known as spread risk, associated with the ABS interest that is otherwise considered part of the credit risk), currency exchange rates, home prices, or of the overall value of a particular broad category of asset-backed securities. Likewise, hedges tied to securities that are backed by similar assets originated and securitized by other sponsors, also would not be prohibited. On the other hand, a security, instrument, derivative or contract generally would be "materially related" to the particular interests or assets that the sponsor is required to retain if the security, instrument, derivative or contract refers to those particular interests or assets or requires payment in circumstances where there is or could reasonably be expected to be a loss due to the credit risk of such interests or assets (e.g., a credit default swap for which the particular interest or asset is the reference asset).

The proposal also addresses other hedges based on indices that may include one or more tranches from a sponsor's asset-backed securities transactions, as well as tranches of asset-backed securities transactions of other sponsors. The proposal provides that holding a security tied to the return of an index (such as the subprime ABX.HE index) would not be considered a prohibited hedge by the retaining sponsor so long as: (i) any class of ABS interests in the issuing entity that were issued in connection with the securitization transaction and that are included in the index represented no more than 10 percent of the dollar-weighted average of all instruments included in the index, and (ii) all classes of ABS interests in all issuing entities that were issued in connection with any securitization transaction in which the sponsor was required to retain an interest pursuant to the proposal and that are included in the index represent, in the aggregate, no more than 20 percent of the dollar-weighted average of all instruments included in the index. These restrictions are designed to prevent a sponsor (or a consolidated affiliate) from evading the hedging restrictions through the purchase of instruments that are based on an index that is composed, to a significant degree, of asset-backed securities from securitization transactions in which a sponsor is required to retain risk under the proposed rules.

The proposal would also prohibit a sponsor and a consolidated affiliate from pledging as collateral for any obligation (including a loan, repurchase agreement, or other financing transaction) any interest or asset that the sponsor is required to retain unless the obligation is with full recourse to the sponsor or consolidated affiliate. Because the lender of a loan that is not with full recourse to the borrower has limited rights against the borrower on default, and may rely more heavily on the collateral pledged (rather than the borrower's assets generally) for repayment, a limited recourse financing supported by a sponsor's risk retention interest may transfer some of the risk of the retained interest to the lender during the term of the loan. If the sponsor or consolidated affiliate pledged the interest or asset to support recourse financing and subsequently allowed (whether by consent, pursuant to the exercise of remedies by the counterparty or otherwise) the interest or asset to be taken by the counterparty to the financing transaction, the sponsor will have violated the prohibition on transfer.

The proposed rules would specify that the issuing entity in a securitization would not be deemed a consolidated affiliate of the sponsor for the securitization even if its financial statements are consolidated with those of the sponsor under applicable accounting standards.[110] This provision is designed to ensure that an issuing entity may continue to engage in hedging activities itself because such activities would be for the

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[110] See proposed rules at §__.2 (definition of "consolidated affiliate").

benefit of all investors in the asset-backed securities.[111] However, if an issuing entity were to obtain credit protection or hedge the exposure on the particular interests or assets that the sponsor is required to retain under the proposal, such credit protection or hedge could negate or limit the sponsor's credit exposure to the securitized assets. Accordingly, under the proposal, any credit protection by or hedging protection obtained by an issuing entity may not cover any ABS interest or asset that the sponsor is required to retain under the rule. For example, if the sponsor uses the vertical approach to risk retention, an issuing entity may purchase (or benefit from) a credit insurance wrap that covers up to 95 percent of the tranches, but not the five percent of such tranches required to be retained by the sponsor.

Request for Comment

96(a). Under the proposal, a sponsor would not be permitted to sell or otherwise transfer any interest or assets that the sponsor is required to retain to any person other than an entity that is and remains a consolidated affiliated. Is the permitted transfer to consolidated affiliates appropriate? 96(b). Why or why not?

97. Is the proposed hedging prohibition appropriately structured?

98(a). Would the proposal inadvertently capture any kinds of hedging that should be permissible? 98(b). If so, please provide specific recommendations on how we can appropriately tailor the requirements.

99. Does the proposed approach appropriately implement the statutory requirement to prohibit direct and indirect hedging?

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[111] For example, the proposal would not prohibit an issuing entity (and indirectly its investors) from being the beneficiary of loan-level private mortgage insurance (PMI) taken out by borrowers in connection with the underlying assets that are securitized.

100(a). Does the proposal permit hedging that is inconsistent with risk retention and should be prohibited? 100(b). If so, please provide specific recommendations on how we can more appropriately tailor the requirements.

101. Are the proposed provisions concerning the pledging of retained assets appropriate? Should the rule instead prohibit the pledging of retained assets even where the financial transaction is recourse to the sponsor or consolidated affiliate?

102(a). Under the proposal, a sponsor (or a consolidated affiliate) would be prohibited from transferring the retained interest or assets until the retained interest or assets were fully repaid or extinguished. Is this appropriate, or should a sponsor be permitted to freely transfer or hedge its retained exposure after a specified period of time? 102(b). If so, should a period of time be established for different types of securitizations?

103. Are the proposal's requirements pertaining to index hedging appropriate?

104. Are the 10 percent and 20 percent thresholds discussed above consistent with market practice and the underlying goals of the statutory risk retention requirements?

105. Should credit protection and hedging by the issuing entity of any portion of the credit risk on the securitized assets be permitted or, because such credit protection and hedges could limit the incentive of investors to conduct due diligence on the securitized assets, should all credit protection and hedging by the issuing entity (other than interest rate and currency risk) be prohibited?

IV. Qualified Residential Mortgages

Section 15G provides that the risk retention requirements shall not apply to an issuance of ABS if all of the assets that collateralize the ABS are QRMs.[112] Section 15G also directs all of the Agencies to define jointly what constitutes a QRM, taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default.[113] Moreover, section 15G requires that the definition of a QRM be "no broader than" the definition of a "qualified mortgage" (QM), as the term is defined under section 129C(b)(2) of the Truth in Lending Act (TILA) (15 U.S.C. 1639C(b)(2)), as amended by the Dodd-Frank Act, and regulations adopted thereunder.[114]

A. Overall Approach to Defining Qualifying Residential Mortgages

In considering how to define a QRM for purposes of the proposed rules, the Agencies were guided by several factors and principles. The sponsor of an ABS that is collateralized solely by QRMs is completely exempt from the risk retention requirement with respect to such securitization. Accordingly, under the statute, a sponsor will not be required to retain any portion of the credit risk associated with the securitization of

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[112] See 15 U.S.C. 78o-11(c)(1)(C)(iii).

[113] See id. at § 78o-11(e)(4).

[114] See id. at § 78o-11(e)(4)(C). As adopted, the text of section 15G(e)(4)(C) cross-references section 129C(c)(2) of TILA for the definition of a QM. However, section 129C(b)(2), and not section 129C(c)(2), of TILA contains the definition of a "qualified mortgage." The legislative history clearly indicates that the reference in the statute to section 129C(c)(2) of TILA (rather than section 129C(b)(2) of TILA) was an inadvertent technical error. See 156 Cong. Rec. S5929 (daily ed. July 15, 2010) (statement of Sen. Christopher Dodd) ("The [conference] report contains the following technical errors: the reference to 'section 129C(c)(2)' in subsection (e)(4)(C) of the new section 15G of the Securities and Exchange Act, created by section 941 of the [Dodd-Frank Act] should read 'section 129C(b)(2).' In addition, the references to 'subsection' in paragraphs (e)(4)(A) and (e)(5) of the newly created section 15G should read 'section.' We intend to correct these in future legislation.").

residential mortgages that meet the requirements to be a QRM. This requirement suggests that the underwriting standards and product features for QRMs should help ensure that such residential mortgages are of very high credit quality.

In considering how to determine if a mortgage is of sufficient credit quality, the Agencies also examined data from several sources. For example, the Agencies reviewed data on mortgage performance supplied by the Applied Analytics division (formerly McDash Analytics) of Lender Processing Services (LPS). To minimize performance differences arising from unobservable changes across products, and to focus on loan performance through stressful environments, for the most part, the Agencies considered data for prime fixed-rate loans originated from 2005 to 2008. This dataset included underwriting and performance information on approximately 8.9 million mortgages.

As is typical among data provided by mortgage servicers, the LPS data do not include detailed information on borrower income and on other debts the borrower may have in addition to the mortgage. For this reason, the Agencies also examined data from the 1992 to 2007 waves of the triennial Survey of Consumer Finances (SCF).[115] Because families' financial conditions will change following the origination of a mortgage, the analysis of SCF data focused on respondents who had purchased their homes either in the survey year or the previous year. This data set included information on approximately

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[115] The SCF is conducted every three years by the Board, in cooperation with the Treasury, to provide detailed information on the finances of U.S. families. The SCF collects information on the balance sheet, pension, income, and other demographic characteristics of U.S. families. To ensure the representativeness of the study, respondents are selected randomly using a scientific sampling methodology that allows a relatively small number of families to represent all types of families in the nation. Additional information on the SCF is available at http://www.federalreserve.gov/pubs/oss/oss2/method.html.

1,500 families. The Agencies also examined a combined data set of loans purchased or securitized by the Enterprises from 1997 to 2009. This data set consisted of more than 75 million mortgages, and included data on loan products and terms, borrower characteristics (e.g., income and credit score), and performance data through the third quarter of 2010.[116]

Based on these and other data, the underwriting and product features established by the Agencies for QRMs include standards related to the borrower's ability and willingness to repay the mortgage (as measured by the borrower's debt-to-income (DTI) ratio); the borrower's credit history; the borrower's down payment amount and sources; the loan-to-value (LTV) ratio for the loan; the form of valuation used in underwriting the loan; the type of mortgage involved; and the owner-occupancy status of the property securing the mortgage. A substantial body of evidence, both in academic literature and developed for this rulemaking, supports the view that loans that meet the minimum standards established by the Agencies have low credit risk even in stressful economic environments that combine high unemployment with sharp drops in house prices.[117]

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[116] Additional information concerning the Enterprise data used by the Agencies in developing the proposed QRM standards is provided in Appendix A to this Supplementary Information.

[117] For the importance of loan-to-value ratio at origination, see Quigley, J. and R. Van Order. "Explicit tests of contingent claims models of mortgage default," Journal of Real Estate Finance and Economics, *11*, 99-117(1995) and the extensive literature that has followed, including Foote, C., K. Gerardi and P. Willen, "Negative equity and foreclosures: theory and evidence," Federal Reserve Bank of Boston Public Policy Discussion Papers Number 08-3. (2008) http://www.bos.frb.org/economic/ppdp/2008/ppdp0803.pdf ; for the importance of credit history, see Barakova, I., R. Bostic, P. Calem, and S. Wachter "Does credit quality matter for homeownership?" Journal of Housing Economics, 12, 318-336 (2003); for several other underwriting criteria see Foote, C., K. Gerardi and P. Willen, "Negative equity and foreclosures: theory and evidence," Federal Reserve Bank of Boston Public Policy

Any set of fixed underwriting rules likely will exclude some creditworthy borrowers. For example, a borrower with substantial liquid assets might be able to sustain an unusually high DTI ratio above the maximum established for a QRM. As this example indicates, in many cases sound underwriting practices require judgment about the relative weight of various risk factors (e.g., the tradeoff between LTV and DTI ratios). These decisions are usually based on complex statistical default models or lender judgment, which will differ across originators and over time. However, incorporating all of the tradeoffs that may prudently be made as part of a secured underwriting process into a regulation would be very difficult without introducing a level of complexity and cost that could undermine any incentives for sponsors to securitize, and originators to originate, QRMs.

The Agencies recognize that many prudently underwritten residential mortgage loans will not meet the proposed definition of a QRM. Sponsors of ABS backed by these mortgages will be required to retain some of the credit risk of these mortgage loans in accordance with the proposed regulation (unless another exemption is available). However, as discussed further in Part III.B of this Supplementary Information, the Agencies have sought to provide sponsors with several options for complying with the risk retention requirements of section 15G so as to reduce the potential for these requirements to disrupt securitization markets, including those for non-QRM residential

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Discussion Papers Number 08-3 (2008).. http://www.bos.frb.org/economic/ppdp/2008/ppdp0803.pdf , Mayer, C., K. Pence and S. M. Sherlund "The rise in mortgage defaults: facts and myths," Manuscript, Federal Reserve Board, Washington DC. (2008), and S. Sherlund, "The past, present, and future of subprime mortgages," Finance and Economics Discussion Series No. 2008-63, Federal Reserve Board, Washington DC (2008). http://www.federalreserve.gov/pubs/feds/2008/200863/200863abs.html mortgages, or materially affect the flow or pricing of credit to borrowers and businesses. Moreover, the amount of non-QRM residential mortgages should be sufficiently large, and include enough prudently underwritten loans, so that ABS backed by non-QRM residential mortgages may be routinely issued and purchased by a wide variety of investors. As a result, the market for such securities should be relatively liquid, all else being equal. Indeed, the broader the definition of a QRM, the less liquid the market ordinarily would be for residential mortgages falling outside the QRM definition.

The Agencies also have sought to make the standards applicable to QRMs transparent to, and verifiable by, originators, securitizers, investors and supervisors. As discussed further below, whether a residential mortgage meets the definition of a QRM can and will be determined at or prior to the time of origination of the mortgage loan. For example, the DTI ratio and the LTV ratio are measured at or prior to the closing of the mortgage transaction. The Agencies believe that this approach should assist originators of all sizes in determining whether residential mortgages will qualify for the QRM exemption, and assist ABS issuers and investors in assessing whether a pool of mortgages will meet the requirements of the QRM exemption. In addition, the approach taken by the proposal would allow individual QRM loans to be modified after securitization without the loan ceasing to be a QRM in order to avoid creating a disincentive to engage in appropriate loan modifications.

In developing the proposed criteria for a QRM, the Agencies also considered how best to address the interaction between the definitions and standards for QRM and QM, as mandated by the Dodd-Frank Act.[118] The Board currently has sole rulemaking

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[118] See 15 U.S.C. § 78o-11(e)(4)(C).

authority for the QM standards, which authority will transfer to the Consumer Financial Protection Bureau (the CFPB) on the designated transfer date, which is set as July 21, 2011 (transfer date). In addition, while Section 15G's risk retention requirements are to be prescribed by the Agencies no later than 270 days after enactment of the Dodd-Frank Act (April 17, 2011), the Dodd-Frank Act provides that the rules implementing the QM standards must be prescribed before the end of the 18-month period beginning on the transfer date.

In light of these provisions, the Agencies propose to incorporate the statutory QM standards, in addition to other requirements, into the QRM requirements and apply those standards strictly in setting the QRM requirements in order to ensure that, consistent with Congress' directive, the definition of a QRM be no broader than a QM. The Agencies have proposed this approach to minimize any potential for conflicts between the QRM standards in the proposed rules and the QM standards that ultimately will be proposed or adopted under TILA, as well as to provide the public a reasonable opportunity to comment on the proposed QRM standards, including those that are bounded by the statutory QM standards. The proposed approach also helps reinforce the goal of ensuring that QRMs are of very high credit quality.

As noted above, rulemaking authority for the QM standards is vested initially in the Board and, after the transfer date, the CFPB. TILA provides the QM rulewriting agency with the authority to establish key aspects of the QM definition (e.g., any qualifying ratios of the borrower's total debt to monthly income) and to revise, add to, or subtract from the criteria for a residential mortgage loan to qualify as a QM.[119]

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[119] See Section 129C(b)(3)(B)(i) of TILA.

Accordingly, the Agencies expect to monitor the rules adopted under TILA to define a QM and will review those rules to determine whether changes to the definition of QRM are necessary or appropriate to ensure that the definition of a QRM is "no broader" than the definition of a QM as defined in section 129C(b)(2) of TILA and to appropriately implement the risk retention requirement of section 15G.[120] In light of the different purposes and effects of the QRM and the QM standards,[121] as well as the different agencies responsible for implementing these standards, the proposed standards for QRMs should not be interpreted in any way as reflecting or suggesting the way in which the QM standards under TILA may be defined either in proposed or final form.

As required by section 15G, the Agencies also considered information regarding the credit risk mitigation effects of mortgage guarantee insurance or other credit enhancements obtained at the time of origination.[122] If such guarantees are backed by sufficient capital, they likely lower the credit risk faced by lenders or purchasers of securities because they typically pay out when borrowers default. Such guarantees have historically been required for loans with higher LTV ratios, where borrowers have

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[120] Under section 15G(e)(4)(C), future changes to the QM definition do not, in and of themselves, alter the QRM definition. The QRM definition will not change until the Agencies have determined, through joint rulemaking, that the QRM definition should be altered.

[121] The function of the QM standard is to provide lenders with a presumption of compliance with the requirement in section 129C(a) of TILA to assess a borrower's ability to repay a residential mortgage loan. The purposes of these provisions are to ensure that consumers are offered and receive residential mortgage loans on terms that reasonably reflect their ability to repay the loans and that are understandable and not unfair, deceptive, or abusive. See section 129B(a)(2) of TILA.

[122] See 15 U.S.C. § 78o-11(e)(4)(B)(iv).

relatively thin equity cushions.[123] Mortgage insurance companies charge a risk-based premium for this insurance, as well as impose additional underwriting restrictions. The Agencies considered a variety of information and reports relative to such guarantees and other credit enhancements. While this insurance protects creditors from losses when borrowers default, the Agencies have not identified studies or historical loan performance data adequately demonstrating that mortgages with such credit enhancements are less likely to default than other mortgages, after adequately controlling for loan underwriting or other factors known to influence credit performance, especially considering the important role of LTV ratios in predicting default. Therefore, the Agencies are not proposing to include any criteria regarding mortgage guarantee insurance or other types of insurance or credit enhancements at this time. The Agencies note that mortgage guarantee insurance is a form of credit enhancement accepted by the Enterprises for mortgages with higher LTV ratios that allows such mortgages to be securitized through mortgage-backed securities guaranteed by the Enterprises. For the reasons explained in Part III.B.8 of this Supplemental Information, under §__.11 of the proposed rules, the guarantee provided by an Enterprise while operating under the conservatorship or receivership of FHFA with capital support from the United States would satisfy the risk retention requirements of the Enterprise with respect to the mortgage-backed securities issued by the Enterprise.

A number of the proposed standards developed for the QRM exemption (e.g., the DTI ratios and acceptable sources of borrower funds) are dependent upon certain

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[123] See National Association of Realtors, "Financing the Home Purchase: The Real Estate Professional's Guide 1993," Chicago: National Association of Realtors, at 20 and 117.

definitions, calculations and verification requirements that are critical to the robustness of the QRM standards. The Agencies believe that it is important to provide clarity on what these definitions, calculations, and verification requirements include for purposes of the QRM standards. The Agencies considered how best to achieve this goal in a manner that is transparent, uniform, and familiar to the mortgage industry. After carefully considering a variety of options, the Agencies propose to incorporate and use certain definitions and key terms established by HUD and required to be used by lenders originating residential mortgages that are insured by the Federal Housing Administration (FHA). Specifically, the proposed rules incorporate the definitions and standards currently set out in the HUD Handbook 4155.1 (New Version), Mortgage Credit Analysis for Mortgage Insurance, as in effect on December 31, 2010 (HUD Handbook)[124] for determining and verifying borrower funds and the borrower's monthly housing debt, total monthly debt and monthly gross income. This proposed approach provides a transparent, uniform and well-known basis for lenders to determine whether a residential mortgage loan qualifies as a QRM, without requiring the Agencies to establish and maintain—and lenders to comply with—new requirements.

In order to facilitate the use of these standards for QRM purposes, the Agencies propose to include in the Additional QRM Standards Appendix of the proposed rules all of the standards in the HUD Handbook that are used for QRM purposes. The only modifications made to the relevant standards in the HUD Handbook would be those necessary to remove those portions unique to the FHA underwriting process (e.g.,

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[124] See HUD Handbook, available at http://www.fhaoutreach.gov/FHAHandbook/prod/contents.asp?address=4155-1.

TOTAL Scorecard instructions). The proposed rules and the Additional QRM Standards Appendix would not affect or change any of the standards in the HUD Handbook as they apply to FHA-insured mortgages. Moreover, HUD continues to have sole authority to modify the HUD Handbook. Any such amendments would not affect the Additional QRM Standards Appendix of the proposed rules unless separately adopted by the Agencies under section 15G.

Request for Comment

106. Is the overall approach taken by the Agencies in defining a QRM appropriate?

107. What impact might the proposed rules have on the market for securitizations backed by QRM and non-QRM residential mortgage loans?

108. What impact, if any, might the proposed QRM standards have on pricing, terms, and availability of non-QRM residential mortgages, including to low and moderate income borrowers?

109(a). The Agencies seek general comment on the overall approach of using certain longstanding HUD standards for certain definitions and standards within the QRM exemption and whether the Agencies should adopt a different approach. 109(b). Are there any other existing, transparent, and widely recognized standards that the Agencies should use for ensuring that lenders follow consistent and sound processes in determining whether a residential mortgage loan meets the qualifications for a QRM?

110. The Agencies seek comment on all aspects of the proposed definition of a QRM, including the specific terms and conditions discussed in the following section.

111(a). The Agencies seek comment on whether mortgage guarantee insurance or other types of insurance or credit enhancements obtained at the time of origination would or would not reduce the risk of default of a residential mortgage that meets the proposed QRM criteria but for a higher adjusted LTV ratio. Commenters are requested to provide historical loan performance data or studies and other factual support for their views if possible, particularly if they control for loan underwriting or other factors known to influence credit performance. 111(b). If the information indicates that such products would reduce the risk of default, should the LTV ratio limits be increased to account for the insurance or credit enhancement? 111(c). If so, by how much?

112(a). If the proposed QRM criteria were adjusted for the inclusion of mortgage guarantee insurance or other types of insurance or credit enhancements, what financial eligibility standards should be incorporated for mortgage insurance or financial product providers and how might those standards be monitored and enforced? 112(b). What disclosure regarding the entity would be appropriate?

113. Are there additional ways that the Agencies could clarify the standards applicable to QRMs to reduce the potential for uncertainty as to whether a residential mortgage loan qualifies as a QRM at origination?

B. Exemption for QRMs

Consistent with section 15G, § __.15(b) of the proposed rules provides that a sponsor is exempt from the risk retention requirements of the proposed rules with respect to any securitization transaction if all of the securitized assets that collateralize the ABS are QRMs, and none of the securitized assets that collateralize the ABS are other ABS.

These conditions implement the requirements in 15 U.S.C. §78o-11(c)(1)(C)(iii) and (e)(5).

Section __.15(b) of the proposed rules includes two additional requirements for a securitization transaction to qualify for the QRM exemption. First, the proposal would require that, at the closing of the securitization transaction, each QRM collateralizing the ABS is currently performing (i.e., the borrower is not 30 days or more past due, in whole or in part, on the mortgage).[125] Because QRMs are completely exempt from the risk retention requirements, the proposed rules would not permit a residential mortgage loan that satisfied the conditions to be a QRM upon origination to be included in an ABS transaction exempt under § __.15(c) of the proposed rules if the loan was not currently performing at the time of closing of the securitization transaction. Second, the depositor[126] for the ABS must certify that it evaluated the effectiveness of its internal supervisory controls for ensuring that all of the assets that collateralize the ABS are QRMs and that it has determined that its internal supervisory controls are effective. This evaluation must be performed as of a date within 60 days prior to the cut-off date (or similar date) for establishing the composition of the collateral pool. The sponsor also must provide, or cause to be provided, a copy of this certification to potential investors a reasonable period of time prior to the sale of ABS and, upon request, to the Commission

[125] See proposed rules at § __.15(a) (definition of "currently performing" for QRM purposes).

[126] See proposed rules at § __.2 (definition of "depositor").

and its appropriate Federal banking agency, if any. These evaluation and certification conditions implement the requirements in 15 U.S.C. § 78o-11(e)(6).[127]

C. Eligibility Criteria

1. Eligible Loans, First Lien, No Subordinate Liens, Original Maturity and Written Application Requirements

The proposed definition limits a QRM to a closed-end first-lien mortgage to purchase or refinance a one-to-four family property, at least one unit of which is the principal dwelling of a borrower.[128] Under the proposal, construction loans, "bridge" loans with a term of twelve months or less, loans to purchase time-share properties, and reverse mortgages could not be QRMs. Construction loans, bridge loans and other loans designed to offer temporary financing have typically not been securitized in the past, and their underwriting is notably more complex than that of standard mortgage loans. Thus, expanding the definition of QRMs to include such loans would be complex and seem to offer few, if any, benefits. Any loan relating to a time share also may not be a QRM, as these types of loans are excluded from the definition of a "residential mortgage loan" that may be a QM under section 103(cc)(5) of TILA.

Even before the financial crisis, the overwhelming majority of reverse mortgages were insured by the FHA.[129] Reverse mortgages insured by the FHA are separately

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[127] For these purposes, the Agencies interpret the term "issuer" as used in section 15G(e)(6) to refer to the depositor for the transaction.

[128] Closed-end credit and the related terms consumer credit and open-end credit are defined in a manner consistent with the definition of such terms under the Board's Regulation Z, which implements TILA.

[129] See Hui Shan, "Reversing the Trend: The Recent Expansion of the Reverse Mortgage Market Finance and Economics Discussion Series," Board of Governors of the Federal

exempted from the risk retention requirements of section 15G.[130] In addition, reverse mortgages may be QMs only to the extent that they meet certain standards to be determined by regulation by the Board or CFPB under section 129C(b)(2)(A)(ix) of TILA. Because the extent to which reverse mortgages may be considered a QM under TILA is not yet known, the Agencies have excluded reverse mortgages from potential QRM status.

Under the proposal, a QRM must be secured by a first-lien, perfected in accordance with applicable law, on the one-to-four family property to be purchased or refinanced. In addition, consistent with the QM requirement under section 129C(b)(2) of TILA, the maturity date of a QRM, at the closing of the mortgage transaction, must not exceed 30 years. A one-to-four family property is defined to mean real property that is (i) held in fee simple, or on leasehold under a lease for not less than 99 years which is renewable, or under a lease having a period that is at least 10 years longer than the mortgage, and (ii) improved by a residential structure that contains one to four units.[131] A one-to-four family property may include an individual condominium or cooperative unit, as well as a manufactured home that is constructed in conformance with the National Manufactured Home Construction and Safety Standards and erected on, or otherwise affixed to, a foundation in accordance with requirements established by the FHA.

Reserve System, 2009-42 (2009), available at http://www.federalreserve.gov/pubs/feds/2009/200942/200942pap.pdf.

[130] See 15 U.S.C. § 78o-11(e)(3)(B).

[131] See proposed rules at §__.15(a) (definition of "one-to-four family property").

If the mortgage transaction is to purchase a one-to-four family property, no other recorded or perfected liens on the one-to-four family property can, to the creditor's knowledge, exist at the time of the closing of the mortgage transaction. Thus, the proposed rules prohibit the use of a junior lien in conjunction with a QRM to purchase a home. Data indicate that, controlling for other factors, including combined LTV ratio, the use of junior liens at origination to decrease down payments—so-called "piggyback" mortgages—significantly increased the risk of default.[132] The proposal would not prohibit the existence of junior liens in connection with the refinancing of an existing loan secured by an owner-occupied one-to-four family property, provided that the combined LTV ratio at closing of the mortgage transaction does not exceed certain thresholds established by the proposed rules.[133] The Agencies have not proposed to prohibit the existence of a junior lien in connection with a refinancing transaction (subject to certain combined LTV limits) because the Agencies recognize that some borrowers may have existing home equity loans or lines of credit and are currently performing on all of their mortgage obligations.[134] A prohibition on junior liens in connection with a refinancing transaction would force such performing borrowers to terminate their existing home equity loans or lines of credit and obtain a new home equity loan or line of credit shortly thereafter, with additional transaction costs (including a loan

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[132] See Kristopher Gerardi, Andreas Lehnert, Shane Sherlund, and Paul S. Willen, "Making Sense of the Subprime Crisis," Brookings Papers on Economic Activity (Fall 2008), at 86, Table 3.

[133] See proposed rules at §__.15(d)(9).

[134] As discussed further below, the proposed rules would require that the borrower be currently performing on all of the borrower's debt obligations—including any current first mortgage, home equity loan or line of credit—for any new mortgage to qualify as a QRM.

origination fee). To help ensure that the borrower continues to have the ability and incentive to repay a QRM that is originated as part of a refinancing transaction, the proposal includes certain combined LTV limits on refinancing transactions and DTI limits both of which assume that any home equity loan or line of credit is fully drawn.

The proposed rules also would require that the borrower complete and submit to the creditor a written application for the mortgage transaction. The application, as supplemented or amended prior to closing of the mortgage transaction, must include an acknowledgement by the borrower that the information provided in the application is true and correct as of the date executed by the borrower, and that any intentional or negligent misrepresentation of the information provided in the application may result in civil liability and/or criminal penalties under 18 U.S.C. 1001.[135] This standard is consistent with the written acknowledgement in the Uniform Residential Loan Application (Form 1003) used by the Enterprises.

Request for Comment

114(a). The Agencies request comment on each of these conditions for QRM eligibility. In addition, should a loan be disqualified from being a QRM if the creditor has "reason to know" of another recorded or perfected lien on the property in a purchase transaction? 114(b). If so, what would constitute a "reason to know" by the creditor?

2. Borrower Credit History

[135] See proposed rules at §__.15(d)(9).

The Agencies' own analysis, as well as work published in academic journals,[136] indicates that borrower credit history is among the most important predictors of default. In many datasets, credit history is proxied using a credit score, often the FICO score determined under the credit scoring model devised by Fair Isaac Corporation. Among the residential mortgage loans in the LPS dataset described above, 13 percent of all loans defaulted (defined as ever having missed three or more consecutive payments or ever being in foreclosure). However, 24.5 percent of residential mortgage loans taken out by borrowers with a FICO score of 690 or below defaulted, compared to a default rate of 7.7 percent among residential mortgage loans taken out by borrowers with a FICO score greater than 690. Even among the higher-FICO group, differences remained: borrowers with FICO scores of 691 to 740 had a default rate of 11.4 percent, while borrowers with FICO scores above 740 had a default rate of 4 percent. Thus, in these data, mortgage borrowers with a FICO score of 690 or below were more than six times as likely to default as borrowers with FICO scores of above 740.

A similar pattern emerges from the SCF data described above. Although the SCF data do not record the borrower's credit score, they do report several important contributors to low credit scores. The most important predictor of whether a household in the SCF data set was delinquent on its mortgage payment was whether it currently was behind on any non-mortgage debt. The second-most important variable was whether the

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136 See, e.g., Avery, Robert B., Raphael Bostic, Paul S. Calem, and Glenn B. Canner, "Credit Risk, Credit Scoring, and the Performance of Home Mortgages," Federal Reserve Bulletin 82(7) 621—48 (1996); Pennington-Cross, Anthony, "Credit History and the Performance of Prime and Nonprime Mortgages," Journal of Real Estate Finance and Economics 27(3) 279—301 (2003); Calem, Paul and Susan Wachter, "Community Reinvestment and Credit Risk: Evidence from an Affordable-Home-Loan Program," Real Estate Economics 27(1) 105—134 (1999).

household had filed for bankruptcy within the past five years. Households that were current on their non-mortgage obligations and had not filed for bankruptcy within the previous five years had a mortgage delinquency rate of 0.2 percent, compared to a delinquency rate of 17.9 percent for other households.

Data on residential mortgages purchased or securitized by the Enterprises also show the importance of borrower credit scores as a predictor of default. From 1997 through 2002, loans that are estimated to meet the proposed QRM requirements (except for credit history) had cumulative rates of serious delinquency ranging from 31 to 44 basis points if the borrower's credit score was above 690, but ranged from 267 to 356 basis points for borrowers with credit scores of 690 or lower. The data show that, in the peak years of the housing bubble (from 2005 to 2007), rates of serious delinquency for loans that were estimated to meet the proposed QRM standards with credit scores above 690 ranged from 186 to 272 basis points, while similar loans to borrowers with lower credit scores ranged from 833 to 1,103 basis points.[137]

In developing the proposal, the Agencies carefully considered how to incorporate a borrower's credit history into the standards for a QRM. The Agencies are aware that credit scores are used often by originators in the loan underwriting process. However, the Agencies do not propose to use a credit score threshold as part of the QRM definition because such a standard would require reliance on credit scoring models developed and maintained by privately owned entities and such models may change materially at the discretion of such entities. There also may be inconsistencies across the various credit scoring models used by consumer reporting agencies, as well as among different scoring

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[137] See Appendix A to this Supplementary Information.

models used by a single provider. Consequently, in order to ensure that creditors could continue to choose among different credit score providers, the Agencies would have to determine a cutoff score under multiple scoring models and periodically revise the regulation in response to new scoring models that might arise.

Instead, the proposed rules define a set of so-called "derogatory factors" relating to a borrower that would disqualify a mortgage for such borrower from qualifying as a QRM. The Agencies considered how these derogatory factors related to the credit scores observed in the data. A 2007 report to Congress by the Board found that, among all persons with a FICO score, 42 percent had scores below 700, 18 percent had scores between 700 and 749, and 40 percent had scores of 750 or above.[138] Thus, the median FICO score is somewhere between 700 and 749. The analysis of the LPS data found that borrowers with prime fixed-rate mortgages with FICO scores below 700 were substantially more likely than the average of such borrowers to default. The Board's report to Congress also found that any major derogatory factor, including being substantially late on any debt payment (not just a mortgage), as well as bankruptcy or foreclosure, would push a borrower's credit score down substantially. Thus, the relatively stringent set of credit history derogatory factors set forth in § __.15(d)(5) of the proposed rules is designed to be a reasonable proxy for the credit score thresholds associated with low delinquency rates in the data.

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[138] See Report to the Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit, Board of Governors of the Federal Reserve System (August 2007), available at http://www.federalreserve.gov/boarddocs/rptcongress/creditscore/creditscore.pdf.

Specifically, under the proposal, a mortgage loan could qualify as a QRM only if the borrower was not currently 30 or more days past due, in whole or in part, on any debt obligation, and the borrower had not been 60 or more days past due, in whole or in part, on any debt obligation within the preceding 24 months. Further, a borrower must not have, within the preceding 36 months, been a debtor in a bankruptcy proceeding, had property repossessed or foreclosed upon, engaged in a short sale or deed-in-lieu of foreclosure, or been subject to a Federal or State judgment for collection of any unpaid debt.

The proposal would require that the originator verify and document, within 90 days prior to the closing of the mortgage transaction, that the borrower satisfied these credit history requirements. The Agencies are proposing a safe harbor that would allow an originator to satisfy the documentation and verification requirements regarding a borrower's credit history by obtaining, no more than 90 days before the closing of the mortgage, credit reports from at least two consumer reporting agencies that compile and maintain files on consumers on a nationwide basis.[139] Such credit reports must demonstrate that the borrower satisfies the credit history requirements for a QRM and the originator must maintain paper or electronic copies of such credit reports in the loan file for the mortgage transaction. This safe harbor would not be available if the creditor later obtained an additional credit report before closing of the mortgage which indicated that the borrower did not meet the proposed rules' credit history requirements.

Request for Comment

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[139] The proposal defines a "consumer reporting agency that compiles and maintains files on a nationwide basis" by reference to the definition of that term in the Fair Credit Reporting Act (15 U.S.C. 1681a(p)). See the proposed rules at §__.15(a)(7).

115. Are the proposed credit history standards useful and appropriate indicators of the likelihood that a borrower might default on a new residential mortgage loan?

116. Are there additional or different standards that should be used in considering how a borrower's credit history may affect the likelihood that the borrower would default on a new mortgage?

117(a). Should the Agencies include minimum credit score thresholds as an additional or alternative QRM standard? 117(b). If so, how might the rules incorporate privately developed credit scoring models in a manner that (i) ensures that borrowers, originators, and investors have adequate notice, and an opportunity to comment on, changes to scoring methodologies that may affect a borrower's eligibility for a QRM, (ii) maintains a level competitive playing field for providers and developers of credit scores, and (iii) ensures that any credit scoring methodology used for QRM purposes is and remains predictive of a borrower's default risk?

118. The Agencies request comment on the appropriateness of the safe harbor that would allow an originator to satisfy the documentation and verification requirements regarding a borrower's credit history by obtaining credit reports from at least two consumer reporting agencies that compile and maintain files on consumers on a nationwide basis.

3. Payment Terms

Section __.15(d)(6) of the proposed rules addresses the payment terms of a QRM, based on the terms of the mortgage transaction at closing. Consistent with the requirements for a QM under section 129C(b)(2)(A)(i) of TILA, the proposed rules would prohibit QRMs from having, among other features, payment terms that allow interest-only payments or negative amortization. Under the proposed rules, regularly scheduled principal and interest payments on the mortgage transaction may not result in an increase of the unpaid principal balance of the mortgage and may not allow the borrower to defer payment of interest or repayment of principal.

In addition, consistent with the requirements for a QM under section 129C(b)(2)(A)(ii) of TILA, the proposed rules would prohibit the terms of a QRM from permitting any "balloon payment," defined for these purposes as a scheduled payment of principal and interest that is more than twice as large as any earlier scheduled payment of principal and interest. This definition of a balloon payment is consistent with the current definition of that term under the Board's Regulation Z, [140] and somewhat more restrictive than the definition of a balloon payment in section 129C(b)(2)(A)(ii) of TILA and applicable to a QM. [141]

Under the proposed rules, both fixed-rate and adjustable-rate mortgages may qualify as a QRM. However, the Agencies are proposing to limit the amount by which interest rates may increase on adjustable-rate loans that are QRMs to reduce the risk of default on QRMs by limiting the potential for consumers to face a "payment shock" in the event that their monthly mortgage payments were to rise rapidly due to expiration of "teaser rate" periods in the early years of a mortgage loan or other interest rate increases. Section 15G(e)(4)(B)(iii) provides that one of the underwriting and product features the Agencies may take into consideration in defining a QRM are those that mitigate "the

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[140] See 12 CFR 226 Supplement I, comment 32 (d)(1)(i)-1 and 12 CFR 226.18(s)(5)(i).

[141] Section 129C(b)(2)(A)(ii) of TILA defines a balloon payment for QM purposes as a scheduled payment that is more than twice as large as the average of earlier scheduled payments.

potential for payment shock on adjustable rate mortgages through product features and underwriting standards." Under § __.15(d)(6)(iii) of the proposed rules, in order for a mortgage that allows the annual rate of interest to increase after the closing of the mortgage transaction to be a QRM, the terms of the mortgage must provide that any such increase may not exceed: (a) two percent (200 basis points) in any twelve month period and (b) six percent (600 basis points) over the life of the mortgage transaction.[142]

Section __.15(d)(6)(iv) of the proposed rules also would prohibit a QRM from containing any prepayment penalty. The term "prepayment penalty" would be defined as a penalty imposed solely because the mortgage obligation is prepaid in full or in part. For purposes of this definition, a prepayment penalty would not include, for example, fees imposed for preparing and providing documents in connection with prepayment, such as a loan payoff statement, a reconveyance, or other document releasing the creditor's security interest in the one-to-four family property securing the loan.

When defining a QRM, section 15G directs the Agencies to take into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default, such as a prohibition or restriction on the use of prepayment penalties.[143] In addition, under section 129C(c)(1)(B) of TILA, prepayment

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142 As described more fully below, an originator also would be required to calculate the borrower's front-end and back-end DTI ratios based on the maximum interest rate permitted during the first five years of the mortgage transaction. Consequently, originators of adjustable-rate mortgages would have to determine that a borrower had acceptable DTI ratios even if rates rose as rapidly as possible under the terms of the mortgage (subject to the annual and lifetime caps described above).

143 15 U.S.C. § 78o-11(e)(4)(B)(v).

penalties are prohibited or subject to significant limitations for certain loans even if those loans otherwise meet the QM definition under section 129C(b)(2) of TILA. [144]

Request for Comment

119(a). The Agencies request comment on all aspects of the proposed rules' limits on the payment terms of a QRM. In addition, the Agencies request comment on the following matters. 119(b). Should additional or different payment terms be established for QRMs? Commenters requesting additional or different limits are encouraged to provide data indicating that such additional or different terms would result in a lower risk of default. 119(c). Would different interest rate caps, such as a one percent (100 basis points) increase in any twelve month period, be more appropriate than the caps set forth in the proposal? 119(d). Recognizing the very damaging effects that prepayment penalties had on some borrowers during the recent housing market distress, the proposed rules do not permit any loans with prepayment penalties to qualify as a

[144] TILA's prepayment penalty restriction scheme is quite complex. Specifically, section 129C(c)(1)(B) of TILA prohibits prepayment penalties for any residential mortgage loan with an adjustable rate, or for those loans where the annual percentage rate exceeds certain thresholds over the average prime offer rate for a comparable transaction, based on the loan's amount and lien status. In addition, where permitted, prepayment penalties may not exceed three percent of the outstanding balance of the loan in the first year, two percent in the second year, and one percent in the third year. Creditors who offer a consumer a loan with a prepayment penalty must also offer the consumer a loan without a prepayment penalty. Under section 129C(b)(2)(A)(vii) of TILA, the total "points and fees" for a QM may not exceed three percent of the total loan amount, and under section 103(aa)(4) of TILA, the definition of "points and fees" now includes the maximum prepayment penalties and fees which may be charged or collected under the terms of the credit transaction. TILA also limits prepayment penalties in section 103(aa)(1)(A)(iii), which defines a "high-cost" mortgage loan as any mortgage (regardless of its cost or other terms) in which the creditor may charge prepayment fees or penalties more than 36 months after the closing of the transaction, or in which the fees or penalties exceed, in the aggregate, more than two (2) percent of the amount prepaid. And under section 129(c) of TILA, as amended by the Dodd-Frank Act, high-cost mortgage loans may not contain prepayment penalties.

QRM. Often, the borrower that suffered because of the existence of such penalties were those with large, unaffordable payment shocks as low initial rates expired or those whose credit standing improved after origination of the loan, but who were not able to benefit from such improvements by refinancing into a potentially lower rate loan. Given the tight credit and product standards proposed for QRMs, such conditions are less likely to be relevant to QRM borrowers, and some QRM borrowers might reasonably benefit from an opportunity to obtain a mortgage with modest prepayment penalties in the early years of the loan in exchange for lower interest rate. Should the Agencies permit prepayment penalties in QRM loans (to the extent otherwise possible within the limits established for QMs)? 119(e). If so, what, if any, limitations should apply to such penalties?

4. Loan-to-Value Ratio

Borrowers with substantial equity in their properties—that is, a low LTV ratio—should in principle default infrequently. If faced with financial hardship, such borrowers typically can sell their homes or otherwise tap their accumulated home equity. To ensure that QRMs have low default risk consistent with their complete exemption from risk retention requirements, the Agencies are proposing that the QRM definition require a sizable equity contribution.

The figure below shows the default rate among loans in the LPS dataset considered by the Agencies (and described above) with the data further restricted to those loans with fully documented income in order to better match the proposed underwriting characteristics of QRMs. These loans are divided by their purpose: to purchase a home, to refinance an existing loan without increasing its principal balance (a so-called "rate and term" refinancing), or to refinance an existing loan and increase the principal balance (a so-called "cash out" refinancing). Different types of mortgage transactions (i.e., purchase, rate and term refinancing, and cash-out refinancing) had varying rates of default.

As shown in the figure below, default rates increase noticeably among loans used to purchase homes at LTV ratios above 80 percent. The precise size of this increase and the LTV ratio at which it occurs are likely to vary across datasets and over time. Nonetheless, lenders have long experience underwriting loans with LTV ratios of 80 percent or less and there is substantial data indicating that loans with LTV ratios of 80 percent or less perform noticeably better than those with LTV ratios above 80 percent.[145] Data from the Enterprises concerning loans purchased or securitized by the Enterprises also show that first-lien purchase loans with high LTV ratios are riskier. The data show that purchase loans estimated to meet other QRM standards, but that exceeded the proposed LTV ratio cap, had serious delinquency rates 80 to 128 basis points higher when examining loans originated from 1997 to 2002, and 287 to 443 basis points higher for loans originated from 2005 to 2007.[146] Based on historical loan performance data, the Agencies are proposing a requirement for a LTV ratio of 80 percent for purchase mortgage transactions.

According to the LPS dataset, loans used to refinance existing mortgages have a greater likelihood of default at every LTV ratio level than those used to purchase homes;

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145 While many creditworthy homebuyers seeking to purchase a home will likely not have the 20 percent down payment required for a QRM, sound underwriting of these loans may well require the prudent use of judgment about the borrower's ability to repay the loan and other risk mitigants that are likely to change over time and vary from borrower to borrower. Such judgments are difficult to incorporate accurately and effectively into a rule without introducing substantial complexity and cost.

146 See Appendix A to this Supplementary Information.

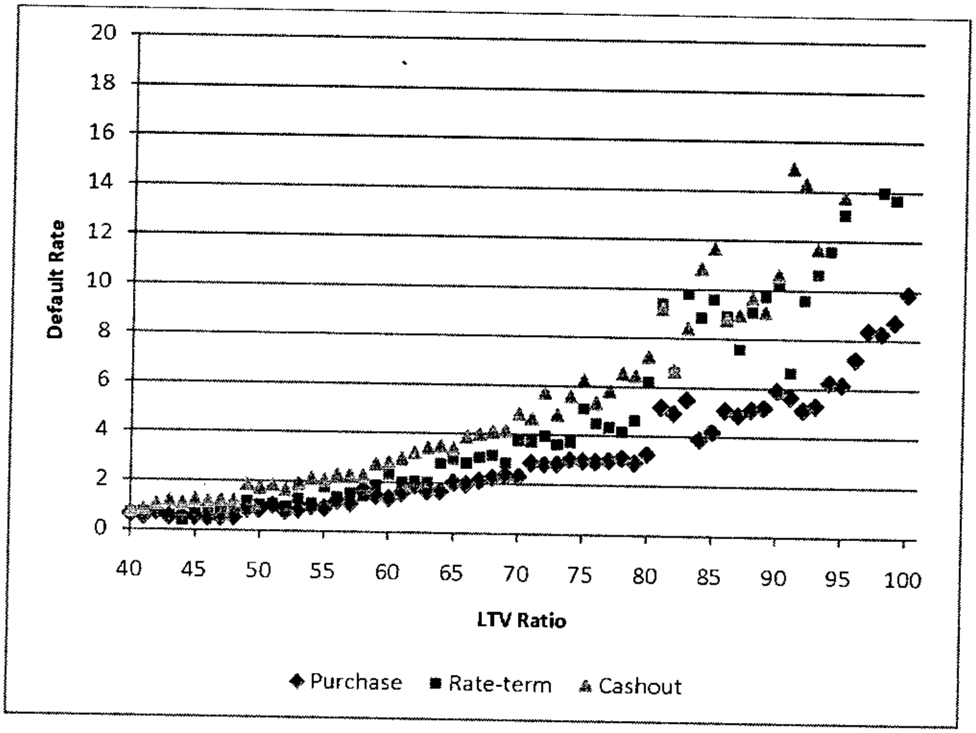
moreover, the default rates are steeper for refinance loans than for purchase loans, suggesting that refinance loans are more sensitive to the LTV ratio. Thus, to control risk of default in a manner consistent with the complete exemption afforded QRMs, the Agencies are proposing that these loans have tighter LTV ratio requirements than purchase loans.

The proposed rules put a combined LTV ratio cap for QRMs of 75 percent on rate and term refinance loans and 70 percent for cash-out refinance loans.[147] Again, estimates of the performance of these loans vary across datasets. However, because they have historically performed worse than purchase loans, and because they are more sensitive to LTV ratios than purchase loans, the lower combined LTV ratio caps on refinance loans should work to reduce risk of default on these loans.

Again, the data from the Enterprises indicates that these LTV ratio caps should significantly reduce the default rate on QRMs that are refinancing transactions. These data show that rate and term refinancings that are estimated to meet other QRM standards, but are estimated to have exceeded the proposed combined LTV cap, had serious delinquency rates 32 to 70 basis points higher when examining loans originated from 1997 to 2002, and 196 to 539 basis points higher for loans originated from 2005 to 2007. For cash-out refinancings that are estimated to meet other QRM standards, but are estimated to have exceeded the proposed combined LTV cap, such loans had serious delinquency rates 42 to 81 basis points higher when examining loans originated between

[147] See proposed rules at § __.15(a) for the proposed definition of a "rate and term refinancing" and a "cash-out refinancing."

1997 and 2002, and 255 to 405 basis points higher when examining loans originated from 2005 to 2007.



Request for Comment

120. The Agencies seek comment on the appropriateness of the proposed LTV and combined LTV ratios for the different types of mortgage transactions.

5. Down Payment

If a mortgage transaction is for the purchase of a one-to-four family property, then the proposed rules require that the borrower provide a cash down payment in an amount equal to at least the sum of:

(i) The closing costs payable by the borrower in connection with the mortgage transaction;

(ii) 20 percent of the lesser of—

(A) The estimated market value of the one-to-four family property as determined by a qualifying appraisal (as described in the following section); and

(B) The purchase price of the one-to-four family property to be paid in connection with the mortgage transaction; and

(iii) If the estimated market value of the one-to-four family property as determined by a qualifying appraisal is less than the purchase price of the one-to-four family property to be paid in connection with the mortgage transaction, the difference between these amounts.

For example, the down payment amount would equal $30,000 on a mortgage transaction with $10,000 in borrower-paid closing costs, and where the purchase price equaled $100,000 on a property with a qualifying appraisal that reflects a $100,000 market value as follows: (i) $10,000 in closing costs; plus (ii) $20,000 (based on 20 percent of the $100,000 purchase price which is less than or equal to the $100,000 market value); plus (iii) $0 (due to purchase price being less than or equal to the market value of the property). However, the down payment amount would equal $40,000 on a mortgage transaction with $10,000 in closing costs, and where the purchase price equaled $110,000 on a property with a qualifying appraisal that reflects a $100,000 market value as follows: (i) $10,000 in closing costs; plus (ii) $20,000 (based on 20 percent of the $100,000 market value which is less than the $110,000 purchase price); plus (iii) $10,000 (difference between the $110,000 purchase price and the $100,000 market value).

Because historical data indicate that borrowers with a meaningful equity interest in their properties exhibit a lower risk of default, [148] the proposal does not permit the dilution of a borrower's equity position by allowing the financing of closing costs.

The proposal also provides that the funds used by the borrower to meet the 20 percent down payment requirement must come from one or more acceptable sources of the borrower's own funds as specified in the Additional QRM Standards Appendix to the proposed rules. The acceptable sources of funds included in the Additional QRM Standards Appendix are those that would be considered acceptable sources under the "Acceptable Sources of Borrower Funds" section in the HUD Handbook (e.g., savings and checking accounts, cash saved at home, stocks and bonds, and gifts, including eligible downpayment assistance programs).

While the down payment must come from acceptable sources of borrower funds, which as noted above can include gifts, the Agencies are proposing to prohibit the use of any funds subject to a contractual obligation by the borrower to repay and any funds from a person or entity with an interest in the sale of the property (other than the borrower). In addition, the Agencies are proposing to require originators to verify and document the borrower's compliance with the down payment requirements in accordance with the verification and documentation standards set forth in the Additional QRM Standards Appendix. Again, these standards are based on the standards in the HUD Handbook.

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[148] See Austin Kelly, "Skin in the Game: Zero Down Payment Mortgage Default," Federal Housing Finance Agency, Journal of Housing Research, Vol. 19, No. 2, 2008, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1330132.

Request for Comment

121. The Agencies request comment on the proposed amount and acceptable sources of funds for the borrower's down payment.

6. Qualifying Appraisal

After considering a variety of valuation information sources, the Agencies are proposing that a QRM be supported by a written appraisal that conforms to generally accepted appraisal standards, as evidenced by the Uniform Standards of Professional Appraisal Practice, the appraisal requirements of the Federal banking agencies, and applicable laws.[149] The Agencies believe these requirements will help ensure that the appraisal is prepared by an independent third party with the experience, competence, and knowledge necessary to provide an accurate and objective valuation based on the property's actual physical condition. These requirements are intended to ensure the integrity of the appraisal process and the accuracy of the estimate of the market value of the residential property.

Request for Comment

122. Should other valuation approaches be considered in determining the value of the real property pledged on the mortgage transaction?

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[149] The appraisal regulations and guidance promulgated by the Federal banking agencies generally do not apply to real estate-related financial transactions that qualify for sale to a U.S. government agency or to the Enterprises, or in which the appraisal conforms to the appropriate Enterprise's appraisal standards applicable to that category of real estate. See 12 CFR 34.43(a)(10) (OCC); 12 CFR 225.63(a)(10); (Board); 12 CFR 323(a)(10) (FDIC). The Interagency Appraisal and Evaluation Guidelines clarify that such transactions are expected to meet all of the underwriting requirements of the appropriate agency or Enterprise, including its appraisal requirements. Residential mortgage loans sold to the Enterprises will, in any case, continue to be required to meet appraisal standards of the appropriate Enterprise applicable to that category of real estate.

7. Ability to Repay

Section 15G provides that, in defining QRMs, the Agencies should take into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default, such as standards with respect to the borrower's residual income,[150] after taking account of all monthly obligations, the ratio of the borrower's housing payment to the borrower's monthly income, or the ratio of the borrower's total monthly installment payments to the borrower's income.[151]

Intuitively, a measure of a borrower's debt service burden ought to be an important predictor of default. These burdens are often measured as the ratio of the borrower's mortgage payment to his gross income (often known as the "front-end ratio") and the ratio of all of the borrower's debt payments to his gross income (often known as the "back-end ratio").[152]

The Agencies' review found that historical loan performance data did not always contain information on the borrowers' monthly income and debt obligations and, where such data were provided, the information was not always captured in a consistent manner, making it difficult to aggregate for statistical analysis. For example, the loan performance data from the Enterprises reflect that borrowers with lower DTI ratios had lower default rates before consideration of other underwriting factors. These data show

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[150] Residual income is the borrower's remaining or "residual" monthly income after all of the borrower's monthly obligations, including the residual mortgage loan, have been paid.

[151] See 15 U.S.C. § 78o-11(e)(4)(B)(ii).

[152] The Agencies' assessment of the available information suggested that the residual income method for assessing the borrowers' ability to repay is neither widely used nor consistently calculated. Therefore, the Agencies are not proposing to require the use of the residual income method for purposes of determining a borrower's ability to repay.

that, among all loan types, loans that are estimated to meet the other proposed QRM standards, but had a front-end ratio of more than 28 percent or a back-end ratio of more than 36 percent, had serious delinquency rates 20 to 39 basis points higher when examining loans originated from 1997 to 2002, and 236 to 359 basis points higher for loans originated from 2005 to 2007.[153]

However, in the LPS data described above, payment to income ratios did not add significant predictive power once the effects of credit history, loan type, and LTV were considered. These results could be due to different originators using different definitions of income and non-mortgage debt burdens. Additionally, loan officers and brokers may only verify and report the minimum income necessary to qualify a borrower for a loan (or for the type of loan or interest rate sought). For example, two borrowers with the same loan type and the same reported front-end DTI ratio might actually have different incomes because one borrower's spouse works, but this additional income was not necessary to qualify for the loan and so was not reported.

The rule proposes a front-end ratio limit of 28 percent and a back-end ratio limit of 36 percent, which are consistent with the overall conservative nature of the QRM standards. These ratios are consistent with the standards widely used in the early 1990s that limited front-end ratios to a maximum of 25 to 28 percent and back-end ratios to a maximum of 33 to 36 percent, with the higher ratios only available to borrowers with relatively large down payments.[154] As noted above and described more fully in Appendix A to this Supplementary Information, loan performance data from the

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[153] See Appendix A to this Supplementary Information.

[154] See National Association of Realtors, "Financing the Home Purchase: The Real Estate Professional's Guide," Chicago: National Association of Realtors (1993), at 20.

Enterprises indicate that these ratios are likely to help contribute to a set of QRM standards indicative of loans of very high credit quality.

For purposes of calculating these proposed ratios, the proposal would require originators to use the borrower's monthly gross income, as determined in accordance with the effective income standards set forth in the HUD Handbook, which have been incorporated into the Additional QRM Standards Appendix to the proposed rules. In addition, originators would be required to use the borrower's monthly housing debt in calculating the front-end ratio, and the borrower's total monthly debt in calculating the back-end ratio, as such debt amounts are defined in the HUD Handbook and incorporated into the Additional QRM Standards Appendix. The proposed rules, however, specifically provide that an originator must include in the borrower's monthly housing debt and total monthly debt any monthly pro rata payments for real estate taxes, insurance, ground rent, special assessments, and homeowner and condominium association dues. This requirement is intended to help ensure that the borrower has the capacity to meet these ongoing, housing-related monthly obligations, even where the borrower does not pay these obligations on a monthly basis.

The proposed rules also require that originators verify and document the borrower's monthly gross income, monthly housing debt, and monthly total debt in accordance with the verification and documentation standards of the HUD Handbook, as incorporated into the Additional QRM Standards Appendix.[155] The proposed rules also require the originator to determine the amount of the monthly first-lien mortgage

[155] Section 129C(b)(2)(A)(iii) of TILA requires that the originator of a QM verify and document the income and financial resources relied upon in qualifying the borrower for the loan.

payment and, in the case of refinancing transactions, the monthly payment for other debt secured by the property (including any open-end credit transaction as if fully drawn) that to the creditor's knowledge would exist at the closing of the refinancing transaction. These determinations would be based on the maximum interest rate chargeable during the first five years after the date on which the first regular periodic payment will be due and a payment schedule that fully amortizes the mortgage over the full term of the loan, which cannot exceed 30 years. These requirements are based on those that apply to QMs under section 129C of TILA.[156]

Request for Comment

123. The Agencies seek comment on the appropriateness of the proposed front-end ratio limit of 28 percent and the proposed back-end ratio limit of 36 percent.

8. Points and Fees

Section __.15(d)(7) of the proposed rules reflects the restriction on "points and fees" for QMs contained in section 129C(b)(2)(A)(vii) of TILA. As with other standards set forth in TILA for QMs, the Agencies have considered the statutory provisions governing points and fees for QMs and have sought to ensure that the standards applicable to QRMs would be no broader than those that may potentially apply to QMs.[157] Under the proposal, in order for a mortgage to be a QRM, the total points and

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[156] See section 129C(b)(2)(A)(iv) and (v) of TILA.

[157] Section 129C(b)(2)(C) of TILA defines the term "points and fees" with reference to the definition of "points and fees" in section 103(aa)(4) of TILA, which deals with "high-cost" mortgages. Under section 103(aa)(4) of TILA, as amended by the Dodd-Frank Act, points and fees include: (i) All items included in the "finance charge" under TILA, except interest or the time-price differential; (ii) All compensation paid directly or indirectly by a consumer or creditor to a mortgage originator (as defined in section 103(cc)(2) of TILA) from any source, including a mortgage originator that is also the creditor in a

fees payable by the borrower in connection with the mortgage transaction may not exceed three percent of the total loan amount, which would be calculated in the same manner as in Regulation Z.[158] Under Regulation Z, the "total loan amount" is calculated by taking the "amount financed," as defined in 12 CFR 226.18(b), and deducting any "points and fees" that are financed by the creditor and not otherwise deducted in calculating the amount financed. In this way, the three percent limit on points and fees for QRMs will

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table-funded transaction; (iii) Each of the charges listed in section 106(e) of TILA (except an escrow for future payment of taxes) that are excluded from the definition of the "finance charge" (under section 106(e) of TILA, the following items when charged in connection with any extension of credit secured by an interest in real property are not included in the computation of the finance charge with respect to that transaction: fees or premiums for title examination, title insurance, or similar purposes; fees for preparation of loan-related documents; escrows for future payments of taxes and insurance; fees for notarizing deeds and other documents; appraisal fees, including fees related to any pest infestation or flood hazard inspections conducted prior to closing; and fees or charges for credit reports), unless the charge is reasonable, the creditor receives no direct or indirect compensation, and the charge is paid to a third party unaffiliated with the creditor; (iv) Premiums or other charges payable at or before closing for any credit life, credit disability, credit unemployment, or credit property insurance, or any other accident, loss-of-income, life or health insurance, or any payments made directly or indirectly for any debt cancellation or suspension agreement or contract, except that insurance premiums or debt cancellation or suspension fees calculated and paid in full on a monthly basis are not considered financed by the creditor; (v) The maximum prepayment fees and penalties that may be charged or collected under the terms of the credit transaction; (vi) All prepayment fees or penalties that are incurred by the consumer if the consumer refinances a previous loan made or currently held by the same creditor or an affiliate of the creditor; and (vii) Such other charges as the Board determines to be appropriate.

For purposes of a "qualified mortgage," section 129C(b)(2)(C) of TILA provides some exceptions to the definition of "points and fees" under section 103(aa)(4) of TILA. In calculating points and fees for purposes of the three percent limit applicable to QMs, points and fees do not include bona fide third party charges not retained by the mortgage originator, creditor, or an affiliate of the creditor or mortgage originator. See section 129C(b)(2)(C)(i) of TILA. In addition, for purposes of computing the total points and fees for the three percent QM limit, the total points and fees excludes certain bona fide discount points if certain conditions are met. See section 129C(b)(2)(C)(ii)-(iv) of TILA.

[158] See 12 CFR 226.32(a)(1)(ii) and (b)(1).

be based on the amount of credit extended to the borrower without taking into account the financed points and fees themselves.

For QRMs, the proposed rules would define "points and fees" consistent with the current definition of "points and fees" under the Board's Regulation Z, but would include the additional items added to the TILA definition of "points and fees" by the Dodd-Frank Act. Specifically, the term "points and fees" would include: (1) All items required to be disclosed as "finance charges" under Regulation Z (12 CFR sections 226.4(a) and 226.4(b)), except interest or the time-price differential; (2) All compensation paid directly or indirectly by a consumer or creditor to a "mortgage originator" (as defined in section 103(cc)(2) of TILA) from any source,[159] including a mortgage originator that is also the creditor in a table-funded transaction;[160] (3) All items excluded from the "finance charge" under Regulation Z listed in 12 CFR section 226.4(c)(7) (other than amounts held for future payment of taxes), unless the charge is reasonable, the creditor and mortgage originator receive no direct or indirect compensation in connection with the charge, and the charge is not paid to an affiliate of the creditor or mortgage originator; (4) Premiums or other charges payable at or before closing for any credit life, credit disability, credit unemployment, or credit property insurance, or any other accident, loss-of-income, life or health insurance, or any payments made directly or indirectly for any debt cancellation or

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[159] Under section 103(aa)(4)(B) of TILA, as amended by the Dodd-Frank Act, compensation paid to a mortgage originator "from any source" is included in "points and fees."

[160] For clarity, the proposal does not include the phrase "from any source" because the proposal would include all compensation paid directly or indirectly by a consumer or creditor to a mortgage originator, which would necessarily include compensation from any source.

suspension agreement or contract;[161] and (5) All prepayment fees or penalties that are incurred by the consumer if the consumer refinances a previous loan made or currently held by the same creditor or an affiliate of the same creditor.[162]

Items excluded from the finance charge under 12 CFR sections 226.4(c), 226.4(d) and 226.4(e) would be excluded from the proposal's definition of "points and fees," unless those items are specifically included elsewhere in the definition of "points and fees." The proposed rules do not exclude "bona fide discount points" or certain bona fide third-party charges from "points and fees." The Agencies are also not proposing an adjustment to the limitation on points and fees for smaller loans as required for QMs under section 129C(b)(2)(D) of TILA.

Request for Comment

124(a). The Agencies request comment on all aspects of the proposed definition of "points and fees" for QRM purposes. In addition, the Agencies seek comment on the following matters. 124(b). Should the exclusion for "bona fide discount points" and certain bona fide third-party charges be included in the final rule? 124(c). If so, in what manner? 124(d) Would an adjustment to the limitation on points and fees for smaller loans, if implemented under section 129C(b)(2)(D) of TILA, be appropriate for QRMs?

9. Assumability Prohibition

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[161] All such charges are included in "points and fees" under section 103(aa)(4)(D) of TILA and, thus, are included in points and fees under the proposal. Another amendment to TILA added by the Dodd-Frank Act (Section 129C(d) of TILA), restricts creditors from financing certain of these charges. This prohibition will be implemented when the Board or CFPB implements that section of TILA.

[162] Section 103(aa)(4) of TILA also includes in "points and fees" the maximum prepayment fees and penalties which may be charged or collected under the terms of the credit transaction. However, under the proposed rule, QRMs would not be permitted to have prepayment penalties.

Under the proposed rules, a QRM could not be assumable by any person who was not a borrower under the original mortgage transaction. If a mortgage were assumable after origination or its securitization, it is possible that the new borrower would not satisfy the QRM requirements, which could result in the credit quality of the mortgage being significantly and negatively affected. While the rule could require that the loan essentially be re-underwritten using the QRM standards in connection with an assumption to address these concerns, such a requirement could impose significant costs on the holder or servicer of the mortgage, and potentially increase the cost and reduce the liquidity of QRMs.

10. Default Mitigation

The proposed rules also would require that the originator of a QRM incorporate into the mortgage transaction documents certain requirements regarding servicing policies and procedures for the mortgage, including requirements regarding loss mitigation actions, subordinate liens, and responsibility for assumption of these requirements if servicing rights with respect to the QRM are sold or transferred. Timely initiation of loss mitigation activities often reduces the risk of subsequent default on mortgages backing the securitization transaction. Disclosure of the policies and procedures governing loss mitigation activities also will inform borrowers and provide clarity regarding the consequences of default.

Specifically, the proposed rules would require that the QRM mortgage transaction documents include a provision obliging the creditor of the QRM to have servicing policies and procedures to promptly initiate activities to mitigate risk of default on the mortgage loan (within 90 days after the mortgage loan becomes delinquent, if such delinquency has not been cured) and to take loss mitigation actions, such as engaging in loan modifications, in the event the estimated net present value of such action exceeds the estimated net present value of recovery through foreclosure, without regard to whether the particular loss mitigation action benefits the interests of a particular class of investors in a securitization. The loss mitigation policies and procedures must also take into account the borrower's ability to repay and other appropriate underwriting criteria. The policies and procedures must include servicing compensation arrangements that are consistent with the creditor's commitment to engage in loss mitigation activities.

In addition, under the proposal, the creditor's policies and procedures would be required to provide that the creditor will implement procedures for addressing any whole loan owned by the creditor (or any of its affiliates) and secured by a subordinate lien on the same property that secures a QRM if the borrower becomes more than 90 days past due on the QRM. If the QRM will collateralize any asset-backed securities, the creditor must disclose those procedures or require them to be disclosed to potential investors within a reasonable period of time prior to the sale of the asset-backed securities. The Agencies are proposing inclusion of this element in the policies and procedures because modification of the QRM could affect the status of subordinate mortgages, and the existence of a subordinate mortgage could affect the structuring of actions to mitigate losses on the QRM.

As proposed, the mortgage originator must provide disclosure of the foregoing default mitigation commitments to the borrower at or prior to the closing of the mortgage transaction. Also, the mortgage originator would be required to include terms in the mortgage transaction documents under which the creditor commits to include in its servicing policies and procedures that it will not sell transfer, or assign servicing rights for the mortgage loan unless the transfer agreement requires the purchaser, transferee or assignee servicer to abide by the default mitigation commitments of the creditor as if the purchaser, transferee or assignee were the creditor under this section of the proposed rule.[163]

It is noted that there is an ongoing interagency effort among certain Federal regulatory agencies, including some of the Agencies joining in this proposed rulemaking, to develop national mortgage servicing standards that would apply to servicers of residential mortgages, including bank and bank-affiliated servicers and servicers that are not affiliated with a bank.[164] These standards would apply to residential mortgages regardless of whether the mortgages are QRMs, are securitized or are held in portfolio by

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[163] As noted above, the policies and procedures prescribed under the proposed rule require the creditor's procedures with respect to subordinate liens held by the creditor or affiliates on the mortgaged property to be disclosed to potential investors if the creditor subsequently securitizes the QRM. In addition, the Agencies expect the creditor's commitments to have servicing policies and procedures as specified in the proposed rule would be reflected in the servicing agreement(s) for the securitization, which set forth the terms under which the servicer will service the securitized assets, and would thus be disclosed to potential investors in a securitization offering covered by the SEC's Regulation AB. If the servicing is transferred from the creditor to another entity who acts as securitization servicer, the Agencies expect these commitments would nevertheless be carried forward to the servicing agreements for the securitizations and disclosed pursuant to Regulation AB, because the policies and procedures prescribed under the proposed rule require the creditor not to transfer QRM servicing unless the agreement requires the transferee to abide by the same kind of default mitigation commitments as are required of the creditor.

[164] Participating agencies in the effort include the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, the Federal Housing Finance Agency, the Department of Housing and Urban Development (including the Government National Mortgage Association (Ginnie Mae)), the Consumer Financial Protection Bureau, and the Department of the Treasury.

a financial institution. The primary objective of this separate interagency effort is to develop a comprehensive, consistent, and enforceable set of servicing standards for residential mortgages that servicers would have to meet. In addition to servicing matters covered in this proposal, the separate interagency effort on national mortgage servicing standards is taking into consideration a number of other aspects of servicing, including the quality of customer service provided throughout the life of a mortgage; the processing and handling of customer payments; foreclosure processing; operational and internal controls; and servicer compensation and payment obligations. The agencies participating in this separate effort currently anticipate requesting comment on proposed standards later this year, with the goal of having final standards issued shortly afterward. At this time, with respect to specific servicing standards, the Agencies are requesting comment only on those particular standards included in this proposed rulemaking.

Request for comment

125. The Agencies solicit comment on whether the definition of QRM should include servicing requirements.

126(a). Should the proposed servicing requirements be more or less robust? 126(b) If so, how should the proposed servicing requirements be changed?

127(a). Should servicers be required, as is proposed, to have policies and procedures that provide for loss mitigation activities if the borrower is 90 days delinquent, but default may not have occurred under the mortgage loan transaction documents? 127(b). Should the policies and procedures require, or at least not prohibit, initiation of loss mitigation activities, including loan modifications, when default is reasonably foreseeable? 127(c). What would be the practical implications of such an approach?

128(a). Should servicers be required, as is proposed, to have policies and procedures that provide for loss mitigation actions for QRMs (within 90 days after delinquency, unless the delinquency is cured) when the estimated net present value of the action would exceed the estimated net present value of recovery through foreclosure? 128(b). Should those policies and procedures be required to include specific actions, such as (i) restructuring the mortgage loan; (ii) reducing the borrower's payments through interest rate reduction, extension of loan maturity, or similar actions; (iii) making principal reductions, or (iv) taking other loss mitigation action in the event that the estimated net present value of that action would exceed the estimated net present value of recovery though loan foreclosure? 128(c). What would be the practical implications of such an approach?

129. The Agencies seek comment on whether other servicing standards should be included, consistent with the statute's authority.

130(a). What are the practical implications of the proposed QRM servicing standards? 130(b). Do commenters envision operational issues in implementing the standards? 130(c). If so, please describe. 130(d). Are the standards sufficiently clear? 130(e). If not, which should be clarified?

131. Would the proposed QRM servicing conditions restrict or impede the ability or willingness of certain classes of originators to originate QRMs?

132(a). Is the scope of the QRM servicing standards appropriate? 132(b). Are there alternatives to QRM servicing standards that would better address servicing issues?

133(a). Should the servicing requirements be part of the pooling and servicing agreement rather than part of the mortgage transaction documents? 133(b).Should they be included in both sets of documentation?

134(a). If a creditor or an affiliate has an ownership interest in a subordinate lien mortgage and the creditor services the first lien mortgage, should the creditor be required to implement pre-defined processes to address any potential conflicts of interest when the first lien loan becomes 90 days past due? 134(b).What types of processes should be required? 134(c).Would specification of a particular process unduly limit the ability of the creditor to address different circumstances that may arise?

135(a). Should the Agencies impose a standard requiring that a particular risk mitigation activity maximize the recovery based on net present value to avoid potential conflicts of interests between different classes of investors? 135(b). How would that be determined? 135(c). Would this approach improve the ability of servicers to best represent the interest of all investors? 135(d). What would be the practical implications under such an approach?

136(a). Are the proposed compensation requirements appropriate? 136(b). For example, should the compensation structure be more specific, depending on the type of risk mitigation action deemed appropriate? 136(c). If so, how?

137(a). Pursuant to servicers' obligations to investors under the terms of securitization transaction documents, servicers are generally required to advance scheduled payments of principal and interest to investors after a borrower has become past due for some period of time (with respect to private label securities, usually until foreclosure is started), to the extent that such monthly advances are expected to be reimbursed from future payments and collections or insurance payments or proceeds of liquidation of the related mortgage loan. These monthly advances are intended to maintain a regular flow of scheduled principal and interest payments on the certificates rather than to guarantee or insure against losses. Does funding of these delinquent payments create liquidity constraints for servicers that incent servicers to take action (e.g., start foreclosure) that may not be in the investors' best interest? 137(b). Should the Agencies put limits on servicers advancing delinquent mortgagors' payments of principal and interest to investors? 137(c). Would such a limitation harm investors' interests? 137(d). What are the practical implications of such an approach?

138(a). Should the Agencies require servicing standards for a broader class of securitized residential mortgages? 138(b). If so, how?

139. For commenters responding to any of the foregoing questions or with recommendations for different or additional approaches to servicing standards, are such approaches consistent with the statutory factors the Agencies are directed to take into account under the QRM exemption?

140. The Agencies are in the process of developing national mortgage servicing standards, which would cover all residential mortgage loans, including QRMs. In light of this, the Agencies seek comment on whether the establishment of national mortgage servicing standards is a more effective means to address the problems associated with servicing of all loans.

D. Repurchase of loans subsequently determined to be non-qualified after closing

As required by section 15G and discussed in greater detail in Part IV.B of this Supplementary Information, the proposed rules require that the depositor of the asset-backed security certify that it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all assets that collateralize the asset-backed security are QRMs and has concluded that such internal supervisory controls are effective. Nevertheless, the Agencies recognize that, despite the use of robust processes and procedures, it is possible that one or more loans included in a QRM securitization transaction may later be determined to have not met the QRM definition due to inadvertent error. For example, an originator conducting post-origination file reviews for compliance or internal audit purposes may find that some aspects of the documentation required to verify the borrower's monthly gross income were not obtained. If the discovery of such an error after closing of the securitization terminated the securitization's QRM exemption, then sponsors and investors may well be unwilling to participate in the securitization of QRMs. On the other hand, unless sponsors or depositors face some penalty for the inclusion in a QRM securitization transaction of loans that do not meet the QRM standards, sponsors and depositors may not have the proper incentives to use all reasonable efforts to ensure that securitizations relying on the QRM exemption are collateralized only by loans that meet all of the QRM standards.

The proposal seeks to balance these interests by providing that a sponsor that has relied on the QRM exemption with respect to a securitization transaction would not lose the exemption, with respect to the transaction, if, after closing of the securitization transaction, it is determined that one or more of the mortgages collateralizing the ABS do not meet all of the criteria to be a QRM, provided that certain conditions are met. First, the depositor must have certified that it evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all of the loans that collateralize the ABS are QRMs and concluded that its internal supervisory controls are effective, as required by §__.15(b)(4) of the proposed rules. Second, the sponsor must repurchase the loan(s) determined to not be QRMs from the issuing entity at a price at least equal to the remaining principal balance and accrued interest on the loan(s). The sponsor must complete this repurchase no later than ninety (90) days after the determination that the loan(s) does not satisfy the QRM requirements. Third, the sponsor must promptly notify (or cause to be notified) all investors of the ABS of any loan(s) that are required to be repurchased by the sponsor pursuant to this repurchase obligation, including the principal amount of the repurchased loan(s) and the cause for such repurchase.

These conditions are intended to provide a sponsor with the opportunity to correct inadvertent errors by promptly repurchasing any non-qualified loan(s) and removing such non-qualifying loan(s) from the pool, while protecting investors. Moreover, in light of this buy-back requirement, sponsors should continue to have a strong economic incentive to ensure that all loans backing a QRM securitization satisfy all of the conditions applicable to QRMs prior to closing of the transaction.

Request for Comment

141(a). Should the Agencies require, as a condition to qualify for the QRM exemption, that the sponsor repurchase the entire pool of loans collateralizing the ABS if the amount or percentage of the loans that are required to be repurchased due to the failure to meet the QRM standards reaches a certain threshold.? 141(b). If so, what threshold would be appropriate?

142(a). Should the Agencies permit a sponsor, within the first four months after the closing of a QRM securitization, to substitute a comparable QRM loan for a residential mortgage loan that is determined, post-closing, to not be a QRM (in lieu of purchasing the loan for cash)? 142(b). If so, is four months an appropriate period or should the rule allow more or less time?

E. Request for Comment on Possible Alternative Approach

As discussed previously, the approach taken by the proposal to implementing the exemption for QRMs within the broader context of section 15G is to limit QRMs to mortgages of very high credit quality, while providing sponsors considerable flexibility in how they meet the risk retention requirements for loans that do not qualify as QRMs (or for another exemption). An alternative approach to implementing the exemption for QRMs within the context of section 15G would be to create a broader definition of a QRM that includes a wider range of mortgages of potentially lower credit quality, and make the risk retention requirements stricter for non-QRM mortgages, such as by, for example, providing sponsors with less flexibility in how they retain risk (e.g., requiring vertical risk retention or increasing the base risk retention requirement), in order to provide additional incentives to originate QRM loans. Under this type of alternative approach, the proposed QRM standards could be modified as follows—

(a) If the mortgage transaction is a purchase transaction or rate and term refinancing, the combined LTV ratio of the mortgage transaction could not exceed 90 percent (with no restriction on the existence of a subordinate lien at closing of a purchase transaction);

(b) If the mortgage transaction is a cash-out refinancing, the combined LTV ratio of the mortgage transaction could not exceed 75 percent;

(c) The borrower's required cash down payment on a purchase mortgage could be reduced to—

(1) 10 percent (rather than the proposed 20 percent) of the lesser of the property's market value or purchase price, plus

(2) The closing costs payable by the borrower in connection with the mortgage transaction; and

(d) A borrower's maximum front-end DTI ratio could be increased to—

(1) 33 percent, if payments under the mortgage could not increase by more than 20 percent over the life of the mortgage; or

(2) 28 percent, if payments under the mortgage could increase by more than 20 percent over the life of the mortgage;

(e) A borrower's maximum back-end DTI ratio would be increased to—

(1) 41 percent, if payments under the mortgage could not increase by more than 20 percent over the life of the mortgage; or

(2) 38 percent, if payments under the mortgage could increase by more than 20 percent over the life of the mortgage; and

(f) Mortgage guarantee insurance or other types of insurance or credit enhancements provided by third parties could be taken into account in determining whether the borrower met the applicable combined LTV requirement, but such insurance or enhancements would not alter the 90 percent maximum combined LTV for purchase transactions and rate and term refinancings and 75 percent maximum combined LTV for cash-out refinancings.

Request for Comment

143. The Agencies seek comment on the potential benefits and costs of the alternative approach, with a broader QRM exemption combined with a stricter set of risk retention requirements for non-QRM mortgages.

144(a). If such an alternative approach were to be adopted, what stricter risk retention requirements would be appropriate in order to provide additional incentives to underwrite a greater share of origination volume within the QRM definition? 144(b). Should such stricter requirements involve the form of risk retention or a higher amount of risk retention? 144(c). Are there other changes that would achieve the same objective?

145. How would this approach help to ensure high quality loan underwriting standards and align the interests of investors?

146(a). Would this approach have the practical effect of exempting the securitization of most residential loans from the risk retention requirement? 146(b). If so, how would this positively and/or negatively affect investors in such securitizations? 146(c). Would an offering of an ABS backed by loans complying with the lower standards in the alternative approach adequately promote the necessary alignment of incentives among originators, sponsors, and investors?

147. What impact might a broader QRM definition have on the pricing, liquidity, and availability of loans that might fall outside the broader QRM boundary?

148. Would the lower QRM standards under the alternative approach be consistent with the requirement that QRMs be fully exempted from section 15G's risk retention requirements?

149. How could this type of alternative approach be designed to limit the likelihood that loans with significant credit risk are included in the pool and thus not subject to risk retention?

V. Reduced Risk Retention Requirements for ABS Backed by Qualifying Commercial Real Estate, Commercial or Automobile Loans

Under Section 15G, the regulations issued by the Agencies must include underwriting standards for residential mortgages, commercial real estate (CRE) loans, commercial loans, and automobile loans, as well as any other asset class that the Federal banking agencies and the Commission deem appropriate.[165] These underwriting standards, which are to be established by the Federal banking agencies, must specify terms, conditions, and characteristics of a loan within such asset class that indicate low credit risk with respect to the loan.[166] Section 15G provides that the Agencies must allow a securitizer to retain less than five percent of the credit risk of loans within an asset class that meet the underwriting standards set jointly by the Federal banking agencies if such loans are securitized through the issuance of an ABS.[167]

The following discussion addresses the underwriting standards established by the Federal banking agencies for CRE loans, commercial loans, and automobile loans.

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165 See 15 U.S.C. § 78o-11(c)(2)(A).

166 See id. at § 78o-11(c)(2)(B).

167 See id. at § 78o-11(c)(1)(B)(ii).

A. Asset classes

As directed by section 15G, §__.18 to §__.20 of the proposed rules include underwriting standards for CRE loans, commercial loans, and automobile loans that would allow ABS backed exclusively by loans that meet these underwriting standards to qualify for a less than five percent risk retention requirement. As discussed in further detail in Part IV of this Supplementary Information, the proposed rules provide a complete exemption from the risk retention requirements for securitization transactions that are collateralized solely by residential mortgages that qualify as QRMs. Accordingly, the proposed rules do establish separate rules for securitizations of residential mortgages that have terms, conditions and characteristics that indicate a low credit risk as required by section 15G(c)(2)(B). The Agencies do not propose to establish additional underwriting standards for residential mortgages that would be different from those set forth in the QRM standards. In determining not to propose additional standards, the Agencies considered, among other things, whether requiring risk retention greater than zero percent but less than five percent would provide an adequate incentive to sponsors and originators to underwrite assets meeting those standards.

Although the Agencies recognize that securitization markets include securitizations collateralized by various subcategories of assets with unique characteristics, the Agencies believe that the asset classes specified in section 15G (e.g., residential mortgages, commercial mortgages, commercial loans and automobile loans) capture a predominance of all ABS issuances by dollar volume where the underlying pool is comprised of relatively homogeneous assets. Moreover, general information for ABS issuances collateralized exclusively by CRE, commercial, and automobile loans is widely available and, due to the homogeneity of the underlying pool, lends itself to the establishment of uniform underwriting standards establishing low credit risk for all of the assets within the pool. These characteristics also should facilitate the ability of investors and supervisors to monitor a sponsor's compliance with the proposed standards and disclosure requirements in a timely and comprehensive manner.

In contrast, many of the other types of ABS issuances are collateralized by assets that exhibit significant heterogeneity, or assets that by their nature exhibit relatively high credit risk. Such factors make it difficult to develop underwriting standards establishing low credit risk that can be, as a practical matter, applicable to an entire class of underlying assets in the manner described under section 15G. Accordingly, for purposes of the proposed rules, the Federal banking agencies and the Commission do not propose to establish asset classes in addition to those set forth in section 15G.

Request for Comment

150(a). Should underwriting standards be developed for residential mortgage loans that are different from those proposed for the QRM definition and under which a sponsor would be required to retain more than zero but less than five percent of the credit risk? 150(b). If so, what should those underwriting standards be and how should they differ from those established under the QRM provisions? 150(c). For example, should such underwriting standards allow for a loan-to-value ratio of up to 90 percent for purchase mortgage loans if there is mortgage insurance that would provide investors similar amounts of loss protection upon default as would be provided by a mortgage with a loan-to-value ratio of 80 percent? 150(d). If additional underwriting standards were established for residential mortgages, what amount of risk retention less than five percent should be required for loans meeting such standards, and should it be required to be held in a particular form?

151. If any new underwriting standards for residential mortgages were to be established and permit the inclusion of mortgage guarantee insurance or other types of insurance or credit enhancements, what financial eligibility standards should be incorporated for mortgage insurance or financial product providers?

152. Should additional asset classes beyond those specified in section 15G be established and, if so, how should the associated underwriting standards for such additional asset classes be defined? Commenters are encouraged to provide supporting data regarding the prevalence of each asset class in the ABS market, as well as loan-level performance data that provides information on the characteristics, terms, and conditions of the underlying loans and that may be useful in developing standards that identify loans within such asset class that have low credit risk.

B. ABS collateralized exclusively by qualifying CRE loans, commercial loans, or auto loans

Section 15G(c)(1)(B)(ii) provides that a sponsor of an ABS issuance collateralized exclusively by loans that meet the underwriting standards prescribed by the Federal banking agencies under section 15G(c)(2)(B) shall be required to retain less than five percent of the credit risk of the securitized loans. The Agencies are proposing a zero percent risk retention requirement (that is, the sponsor would not be required to retain any portion of the credit risk) for ABS issuances collateralized exclusively by loans from one of the asset classes specified in the proposed rules, and which meet the proposed underwriting standards. In proposing a zero risk retention requirement for ABS backed by qualifying loans within these asset classes, the Agencies considered several factors. As discussed below, the underwriting standards the Agencies propose are, as is appropriate for a zero percent risk retention requirement, very conservative. In addition, the Agencies were concerned that establishing a risk retention requirement between zero and five percent for qualifying assets within these asset classes may not sufficiently incent securitizers to allocate the resources necessary to ensure that the collateral backing an ABS issuance satisfies the proposed underwriting standards, as there may be significant compliance costs to structure and maintain the retention piece of a securitization structure (irrespective of how it is calibrated) and provide required disclosures to investors.

Sections__.18 to __.20 of the proposed rules establish underwriting standards for CRE loans, commercial loans, and automobile loans that are designed to ensure that loans in these asset classes, which qualify for a zero risk retention requirement, are of very low credit risk. The proposed underwriting standards are based on the Federal banking agencies' expertise and supervisory experience with respect to the credit risk of the loans in each of the prescribed asset classes. Commercial, CRE and automobile loans that meet the conservative underwriting standards included in the proposed rules are referred to as "qualifying" commercial, CRE and automobile loans.

The Federal banking agencies have sought to make the standards for qualifying commercial loans, CRE loans and automobile loans, transparent to, and verifiable by, originators, securitizers, investors and supervisors. To facilitate compliance with the rule, as well as the supervision and enforcement of the rule, the proposed standards are generally prescriptive, rather than principle-based.

The Agencies recognize that many prudently underwritten CRE, commercial and automobile loans will not meet the underwriting standards set forth in §__.18 to §__.20 of the proposed rules. For example, the Agencies note that the proposed standards are significantly more prudent and conservative than those required to attain a "pass" credit under the Federal banking agencies' supervisory practices. Sponsors of ABS backed by loans that do not meet the underwriting standards will be required to retain some of the credit risk of the securitized loans in accordance with the proposed regulation (unless another exemption is available). However, as noted previously, the proposed rules provide sponsors with several options for complying with the risk retention requirements of section 15G so as to reduce the potential for these requirements to disrupt securitization markets or materially affect the flow or pricing of credit to borrowers and businesses. Moreover, the national pool of commercial loans, CRE loans and automobile loans that do not meet the standards set forth in §__.18 to §__.20 of the proposed rules should be sufficiently large, and include enough prudently underwritten loans, so that ABS backed by such loans will be routinely issued and purchased by a wide variety of investors. As a result, the market for such securities should be relatively liquid.

Request for Comment

153. The Agencies request comment on the appropriateness of a total exemption for sponsors of ABS issuances collateralized exclusively by qualifying CRE, commercial, or automobile loans that meet the underwriting standards set forth in §__.18 to §__.20 of the proposed rules. Commenters who support a partial exemption are encouraged to provide information regarding the methodology the Agencies should use to calibrate the

retention requirement, in a manner that considers the relative risk of the securitization transaction, both within and across the proposed asset classes.

C. Qualifying commercial loans

For an ABS issuance collateralized exclusively by commercial loans to qualify for a zero percent risk retention requirement, the commercial loans must satisfy the underwriting standards set forth in §__.18 of the proposed rules. The proposed rules define a commercial loan as any secured or unsecured loan to a company or an individual for business purposes, other than a loan to purchase or refinance a one-to-four family residential property, a loan for the purpose of financing agricultural production, or a loan for which the primary source (that is, 50 percent or more) of repayment is expected to be derived from rents collected from persons or entities that are not affiliates of the borrower. Commercial loans encompass a wide variety of credit types and terms. However, these loans generally are similar in that the primary source of repayment is revenue from the business operations of the borrower. The standards for a qualifying commercial loan use measures that are consistent with, but more prudent and conservative than, industry standards for evaluating the financial condition and repayment capacity of a borrower.

1. Ability to repay

The historical performance of a borrower with respect to its outstanding loan obligations is, generally, a useful measure for evaluating whether the borrower will likely satisfy new debt obligations. However, even where a borrower has a consistent and documented record of satisfactory performance on prior debt obligations, the originator also must ensure that the borrower's financial condition has not changed in a way that could adversely affect its capacity to satisfy new loan obligations. Accordingly, under §__.18 of the proposed rules, the originator of a qualifying commercial loan must verify and document the financial condition of the borrower as of the end of the borrower's two most recently completed fiscal years. In addition, the originator must conduct an analysis of the borrower's ability to service its overall debt obligations during the next two years, based on reasonable projections. A commercial loan would meet the standards in the proposed rules only if the originator determines that, during the borrower's two most recently completed fiscal years and the two-year period after the closing of the commercial loan, the borrower had, or is expected to have: (1) a total liabilities ratio[168] of 50 percent or less; (2) a leverage ratio[169] of 3.0 or less; and (3) a debt service coverage (DSC) ratio[170] of 1.5 or greater.

Under the proposed rules, the loan payments under the commercial loan must be determined based on straight-line amortization of principal and interest that fully amortize the debt over a term that does not exceed five years from the closing date for the loan. In addition, the loan documentation must require payments no less frequently than quarterly over a term that does not exceed five years. The Federal banking agencies believe these proposed methods for assessing a borrower's financial condition and ability

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[168] Total liabilities ratio equals the borrower's total liabilities, determined in accordance with GAAP divided by the sum of the borrower's total liabilities and equity, less the borrower's intangible assets, with each component determined in accordance with GAAP.

[169] The leverage ratio equals the borrower's total debt divided by the borrower's annual income before expenses for interest, tax, depreciation, and amortization (EBITDA), as determined in accordance with GAAP.

[170] The DSC ratio equals the borrower's EBITDA, as of the most recently completed fiscal year divided by the sum of the borrower's annual payments for principal and interest on any debt obligation.

to repay are consistent with industry standards for evaluating the financial condition and repayment capacity of a borrower.

The proposal does not require that a commercial loan be secured by collateral in order to be a qualifying commercial loan. However, where the loan is made on a secured basis, the proposed rules include several conditions designed to ensure that the collateral is maintained and available to be used to satisfy the borrower's obligations under the loan, if necessary. For example, if the commercial loan is originated on a secured basis, the originator must obtain a first-lien security interest on the pledged property and include covenants in the loan agreement that require the borrower to maintain the condition of the collateral and permit the originator to inspect the collateral and the books and records of the borrower. The loan documentation for the commercial loan also must include covenants that require the borrower to: (a) pay all applicable taxes, fees, charges and claims where nonpayment could give rise to a lien against the collateral; (b) take any action necessary to perfect or defend the security interest (or priority of the security interest) of the originator (or any subsequent holder of the loan) in the collateral against claims adverse to the lender's interest; and (c) maintain insurance that protects against loss on the collateral at least up to the amount of the loan, and that names the originator (or any subsequent holder of the loan) as an additional insured or loss payee.

2. Risk management and monitoring requirements

To mitigate default risk during periods of economic stress or when the financial condition of the borrower otherwise deteriorates, the proposed rules require the loan documentation to include covenants that restrict the borrower's ability to incur additional debt or transfer or pledge its assets. Specifically, the proposed rules require the loan documentation to provide certain covenants, including a covenant to provide to the originator (or any subsequent holder) and the servicer financial information and supporting schedules on an ongoing basis, but not less frequently than quarterly. The covenants must also prohibit the borrower from retaining or entering into a debt arrangement that permits payments-in-kind, and place limitations on the transfer of any of the borrower's assets, on the borrower's ability to create other security interests with respect to any of its assets, and on any change to the name, location, or organizational structure of the borrower (or any other party that pledges collateral for the loan). The loan documentation must also include covenants designed to protect the value of any collateral pledged to secure the loan that require the borrower (and any other party that pledges collateral for the loan) to: (a) maintain insurance protecting against loss on any collateral at least up to the amount of the loan and names the originator (or any subsequent holder) as an additional insured, loss payee, or similar beneficiary; (b) pay any taxes, charges, claims and fees where nonpayment could give rise to a lien against any collateral securing the loan; (c) take any action necessary to perfect or defend the security interest of the originator or any subsequent holder of the loan in the collateral for the commercial loan or the priority thereof, and to defend the collateral against claims adverse to the lender's interest; (d) permit the originator or any subsequent holder of the loan, and the servicer of the loan, to inspect the collateral and the books and records of the borrower; and (e) maintain the physical condition of any collateral for the loan.

Request for Comment

154(a). Are the proposed standards appropriate for a qualifying commercial loan? 154(b) Are these standards sufficient and appropriate to ensure that qualifying commercial loans are of very low credit risk?

155. Are the metrics to measure a borrower's financial capacity, and the specified parameter for each metric, an appropriate standard?

D. Qualifying CRE loans

Section __.19 of the proposed rules provides the underwriting standards for qualifying CRE loans. Such standards focus predominately on the following criteria: the borrower's ability to repay the loan; the value of, and the originator's security interest in, the collateral; the LTV ratio; and whether the loan documentation includes the appropriate covenants to protect the collateral.

For purposes of the proposed rules, a CRE loan is defined as a loan secured by a property with five or more single-family units, or by nonfarm non-residential real property, the primary source (50 percent or more) of repayment for which is expected to be derived from: (a) the proceeds of the sale, refinancing, or permanent financing of the property; or (b) rental income associated with the property other than rental income that is derived from any affiliate of the borrower. However, under the proposal, a CRE loan does not include a land development and construction loan (including one-to-four family residential or commercial construction loans), loans on raw or unimproved land, a loan to a real estate investment trust (REIT), or an unsecured loan.

1. Ability to repay

The Federal banking agencies believe that prudent underwriting standards should require the originator to verify and document the capacity of the borrower, or income from the underlying collateral, to repay the loan. For qualifying CRE loans, the proposed underwriting standards focus on both the sufficiency of the CRE property's net operating income (NOI)[171] less replacement reserves to support the payment of principal and interest over the full term of the CRE loan, as well as the financial condition of the borrower (independent of the CRE property's NOI less replacement reserves) to repay other outstanding debt obligations. Specifically, the proposed rules generally require the borrower to have a DSC ratio[172] of 1.7 or greater. The proposed rules, however, would allow a CRE loan on properties with a demonstrated history of stable NOI to have a slightly lower (1.5) DSC ratio. To qualify for the lower DSC ratio requirement, the CRE loan must be secured by either (1) a residential property (other than a hotel, motel, inn, hospital, nursing home, or other similar facility where dwellings are not leased to residents) that consists of five or more dwelling units primarily for residential use, and where at least 75 percent of the CRE property's NOI is derived from residential rents and tenant amenities (such as a swimming pool, gym membership, or parking fees); or (2) commercial nonfarm real property (other than a multi-family property or a hotel, inn or similar property) that is occupied by, and derives at least 80 percent of its aggregate

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[171] Section __.16 of the proposed rules defines NOI as income generated by a CRE property, net of all expenses that have been deducted for federal income tax purposes (except depreciation, debt service expenses, and federal and state income taxes) and any unusual or nonrecurring income items.

[172] Under § __.16 of the proposed rules (definition of "Debt service coverage (DSC) ratio"), the DSC ratio for a CRE loan equals the CRE property's annual NOI less the annual replacement reserve of the CRE property at the time of origination divided by the sum of the borrower's annual payments for principal and interest on any debt obligation.

gross revenue from, one or more "qualified tenants." Under the proposed rules, a qualified tenant is defined as a tenant that (1) is subject to a triple net lease[173] that is current and performing with respect to the CRE property, or (2) was subject to a triple net lease that has expired, currently is leasing the property on a month-to-month basis, has occupied the property for at least three years prior to closing, and is current and performing with respect to all obligations associated with the CRE property. All outstanding triple net leases must have a remaining maturity of at least six months, unless the tenant leases the property on a month-to-month basis as described above.

Under the proposed rules, the originator of a qualifying CRE loan must also determine whether the borrower has the ability to service its other outstanding debt obligations, net of any income generated from the CRE (based on the NOI). This requirement is intended to ensure that the CRE remains a reliable source of repayment and security for the CRE loan, and not other debts of the borrower, over the full loan term. Accordingly, under the proposed rules, the originator must conduct an analysis of the borrower's ability, and determine that the borrower has the ability, to service all outstanding debt obligations over the two years following the origination date for the loan, based on reasonable projections and including the new debt obligation. A borrower's historical performance in satisfying debt obligations is often an indicator of whether the borrower will satisfy a new debt obligation. Accordingly, as part of this analysis, the originator also must document and verify that the borrower has satisfied all debt obligations over a look-back period of at least two years.

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[173] For purposes of the proposed rules, a triple net lease means a lease pursuant to which the lessee is required to pay rent as well as taxes, insurance, and maintenance expenses associated with the property.

The proposed rules generally require that a qualifying CRE loan have a fixed stated interest rate to reduce the potential for the borrower to experience payment shock. However, the proposed rules allow the interest rate to be adjustable if the borrower obtains, prior to or concurrently with the origination date for the CRE loan, a derivative product that effectively results in the borrower paying a fixed interest rate on the CRE loan. Commercial borrowers often purchase a derivative (such as an interest rate swap) that effectively "convert" an adjustable rate into a fixed rate. In addition, the proposed standards for qualifying CRE loans would prohibit terms that (1) permit the borrower to defer principal or interest payments; (2) allow the originator to establish an interest reserve to fund all or part of a payment on the loan; or, (3) provide a maturity date that is earlier than ten years following the closing date for the loan. Further, the loan payment amount must be based on straight-line amortization of the debt over the term of the loan not to exceed twenty (20) years, with payments made no less frequently than monthly over a term of at least ten (10) years.

2. Loan-to-value requirement

The Agencies believe that prudent underwriting standards should limit the amount an originator may advance relative to the market value of the CRE property. Therefore, the Federal banking agencies are proposing to require a combined loan-to-value (CLTV) ratio of less than or equal to 65 percent for qualifying CRE loans. However, the recent crisis has demonstrated that the use of very low capitalization rates generally results in significantly higher market values for some CRE properties. Where the capitalization rate used in the appraisal is less than the 10-year interest rate swap rate[174] plus 300 basis points, the maximum CLTV ratio requirement will be 60 percent to mitigate the effect of an artificially low capitalization rate.

3. Valuation of the collateral

Because the credit risk of a CRE loan is closely linked with the commercial real estate collateralizing the loan, the proposed rules include several conditions relating to the collateral. For example, under §__.19(b) of the proposed rules, the originator of a qualifying CRE loan must determine whether the purchase price for the CRE property that secures the loan reflects the current market value of the property, so as to ensure that the collateral is sufficient to recover any unpaid principal in the event of default, and that the borrower has sufficient equity in the property to incent continued performance of all loan obligations during an economic downturn or when the CRE property's NOI may not be sufficient to cover loan payments. To determine the value of the CRE property, the proposed rules require the originator to obtain an appraisal prepared not more than six months before the origination date for the loan, in accordance with the Uniform Standards of Professional Appraisal Practice and the appraisal requirements of the Federal banking agencies for the CRE property securing the loan. The appraisal report must provide an "as is" opinion of the current market value of the CRE property, which includes an income approach that uses a discounted cash flow analysis based on the CRE property's actual NOI. These requirements are intended to help ensure that the appraisal is prepared by an independent third party with the experience, competence, and

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[174] The 10-year interest rate swap rate is as reported on the previous day's Federal Reserve Statistical Release H.15: Selected Interest Rates.

knowledge necessary to provide an accurate and objective valuation based on the CRE property's actual physical condition.

Environmental hazards, such as ground water contamination and the presence of lead or other harmful chemicals or substances, may potentially jeopardize the value of CRE property as well as the borrower's ability to repay the loan. Accordingly, under the proposed rules, the originator also must conduct an environmental risk assessment of the CRE property securing a qualifying CRE loan and, based on this assessment, take appropriate measures to mitigate any risk of loss to the value of the CRE property. Appropriate measures may include a reduction in the loan amount sufficient to reflect potential losses; however, where the assessment reveals significant environmental hazards, originators are encouraged to reconsider the primary loan decision. The originator can have a qualified third party perform the assessment, but remains responsible for ensuring that appropriate measures are taken to mitigate any risk of loss due to environmental risks.

4. Risk management and monitoring requirements

Under §__.19(b) of the proposed rules, the CRE loan documentation must provide certain covenants that are generally designed to facilitate the ability of the originator to monitor and manage credit risk over the full term of the loan. In developing the proposed covenants, the Federal banking agencies reviewed the supporting loan documentation for several recent ABS issuances collateralized by CRE loans. The proposed covenants are generally consistent with those provided in such loan documentation and, therefore, should reflect current industry practice and impose minimal compliance burden.

As with the covenants required for commercial loans (as discussed in the previous section), the covenants for CRE loans require certain information be provided to the originator (or any subsequent holder) and the servicer financial on an ongoing basis. Additionally, with respect to CRE loans in particular, such information must include information on existing, maturing, and new leasing or rent-roll activity, as appropriate for the CRE property. This should assist the originator in monitoring volatility in the repayment capacity of the borrower, with respect to the CRE property's NOI and the borrower's financial condition.

The loan documentation for a qualifying CRE loan also must include covenants restricting the ability of the borrower to create additional security interests with respect to the CRE property and covenants designed to help maintain the value of, and protect the originator's (or any subsequent holder's) security interest in, the collateral. These covenants are substantially the same as the covenants required for commercial loans (as discussed above). Additionally, a covenant must be included that requires the borrower to comply with all legal or contractual obligations applicable to the collateral. Finally, the loan documentation must include a covenant that prohibits the borrower from pledging the CRE property as security for another loan, even where doing so results in the creation of a subordinate lien. The Agencies note, however, that the proposed rules provide an exception for loans that finance the purchase of machinery and equipment that is pledged as additional collateral for the CRE loan. This restriction is intended to ensure that the CRE property remains a reliable source of repayment and security for the CRE loan and the borrower does not become overleveraged, which could threaten the borrower's ability to repay the CRE loan. The proposed covenants must be applicable to the borrower as well as any other party who provides collateral for the loan.

Request for Comment

156(a). Are the proposed requirements for a qualifying CRE loan appropriate? 156(b). Are these standards sufficient to ensure that qualifying CRE loans have very low credit risk?

157. Are the DSC metrics employed for measuring a borrower's financial capacity, and the specified parameter for each type of CRE property, an appropriate standard?

158. The Agencies are proposing the same DSC ratio (1.5) for qualifying leased CRE loans and qualifying multifamily CRE loans, where the DSC analysis is based on at least two years of actual performance. The Agencies request comment whether the risk of default for qualifying non-Enterprise multifamily CRE loans is demonstrably lower as to justify a lower DSC ratio (such as 1.3). For example, the Agencies acknowledge that several highly-publicized defaults on large multifamily CRE loans had a much weaker structure (e.g., pro-forma underwritten DSC ratio or DSC ratio lower than 1.2) than what is contained in the proposed rules. Commenters should provide relevant criteria to be applied to qualify for a reduced DSC ratio and multifamily CRE loan performance data supporting the conclusion that multifamily loans meeting such criteria, as a class, have a correspondingly reduced risk of default to support a reduced DSC ratio for such loans.

D. Qualifying automobile loans

§__.20 of the proposed rules provides underwriting standards for qualifying automobile loans. Although automobile loans involve secured financing, the collateral represents a highly depreciable asset. Accordingly, in developing the proposed underwriting standards for qualifying automobile loans, the Federal banking agencies sought to establish conservative requirements that are consistent with underwriting standards commonly used by the industry for unsecured installment credits. The proposed rules define an automobile loan as a loan to an individual to finance the purchase of, and secured by a first lien on, a passenger car or other passenger vehicle, such as a minivan, van, sport-utility vehicle, pickup truck, or similar light truck for personal, family, or household use. Under the proposed rules, an automobile loan would not include: (a) any loan to finance fleet sales; (b) a personal cash loan secured by a previously purchased automobile; (c) a loan to finance the purchase of a commercial vehicle or farm equipment that is not used for personal, family, or household purposes; (d) any lease financing; or (e) a loan to finance the purchase of a vehicle with a salvage title.[175] A qualifying automobile loan may be for a new[176] or used vehicle.[177]

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175 Under the proposed rules, a new vehicle is one that is not a used vehicle and has not been previously sold to an end user. A used vehicle is any vehicle driven more than the limited use necessary in transporting or road testing the vehicle prior to the initial sale of the vehicle and does not include any vehicle sold only for scrap or parts (title documents surrendered to the State and a salvage certificate issued). Salvage title is a form of vehicle title branding by an insurance company paying a claim on the vehicle, where the vehicle title notes that the vehicle has been severely damaged and/or deemed a total loss and uneconomical to repair.

176 A new vehicle is one that is not a used vehicle and has not been previously sold to an end user.

177 A used vehicle is any vehicle driven more than the limited use necessary in transporting or road testing the vehicle prior to the initial sale of the vehicle and does not include any vehicle sold only for scrap or parts (title documents surrendered to the State and a salvage certificate issued).

1. Ability to repay

A borrower's ability to repay an automobile loan primarily hinges on the amount of the borrower's monthly total debt obligations in relation to the borrower's monthly income. The Agencies have sought to establish standards for the verification and documentation of a borrower's ability to repay an automobile loan that will help ensure that the loan is of very low credit risk. At the same time, the proposed standards seek to reflect the nature of automobile loans and allow originators to make qualifying automobile loans without undue burden or disruption to existing methods for making automobile loans. For example, originators of automobile loans typically do not verify all of a borrower's income and debt obligations prior to making an automobile loan and requiring an originator to do so could significantly limit any incentive an originator might otherwise have to underwrite loans in accordance with the standards for a qualifying automobile loan. The Federal banking agencies have sought to balance these considerations in developing the proposed underwriting standards.

Under the proposed rules, the borrower under a qualifying automobile loan must have a monthly DTI ratio of less than or equal to 36 percent, consistent with the proposed DTI ratio requirement for QRM loans. The originator must make this determination, and document the underlying analysis, upon origination of the loan.

Originators typically consider a borrower's income and debts in the credit approval process; however, the income history requirements of and the type of information considered by the originator vary widely across the industry. The Agencies believe that the use of consistent underwriting standards, to the extent practical and consistent with industry practice, should reduce implementation burden and ensure that all ABS issuances that qualify for an exemption from the risk retention requirement of the proposed rules are collateralized by high-quality, low credit risk loans. Based on the Federal banking agencies' supervisory experience in overseeing automobile lending, and in an effort to address these inconsistencies, the Federal banking agencies propose to require that originators verify and document the borrower's income using payroll stubs, tax returns, profit and loss statements, or other similar documentation, and that originators verify that all outstanding debts reported in a borrower's credit report are incorporated into the calculation of the borrower's ratio of total debt to monthly income (DTI ratio). For the borrower's monthly debt obligations, the Agencies propose to require the originator to obtain information from the borrower about all monthly housing payments (rent- or mortgage-related, including any property taxes, insurance, and home owners association fees), plus any of the following that are dependent on the borrower's income for payment: (1) monthly payments on all debt and lease obligations (such as installment loans or credit card loans), including the monthly amount due on the automobile loan; (2) estimated monthly amortizing payments for any term debt, debts with other than monthly payments, and debts not in repayment (for example, deferred student loans, interest-only loans); and (3) any required monthly alimony, child support, or court-ordered payments. These elements are generally consistent many of the elements taken into account for the DTI requirement for the QRM standards

2. Loan terms

The Federal banking agencies have found that, in supervising credit risk for such highly depreciable assets as automobiles, a fixed payment amount helps ensure that a borrower will have the ability to repay a loan over the life of the credit. Therefore, the proposed rules require qualifying automobile loans to provide for a fixed interest rate. In addition, under the proposal, the monthly payment must be calculated using straight-line amortization for the term of the loan, not to exceed five years, with the first payment due within 45 days of the closing date. The proposed rules also prohibit loan terms that permit a borrower to defer repayment of principal or interest.

If the loan is for a new vehicle, the proposal would require the loan agreement provide a maturity date for the loan that does not exceed 5 years from the date of closing. If the loan is for a used vehicle, the loan agreement must provide that the term of the loan, plus the difference between the current model year and the vehicle's model year, cannot exceed 5 years. In addition, under the proposed rules, the transaction documents must require that the originator, subsequent holder of the loan, or any agent of the originator or subsequent holder maintain physical possession of the vehicle title until the loan is repaid in full and the borrower has satisfied all obligations under the loan agreement.

3. Reviewing credit history

The supervisory experience of the Federal banking agencies has shown that the historical payment performance of a borrower often is indicative of the borrower's ability to manage debt and willingness to repay a new loan. Accordingly, the proposed rules require the originator to verify and document, within 30 days of the origination date for a qualifying automobile loan, that the borrower (1) is not currently 30 days or more past due, in whole or in part, on any debt obligation and (2) has not been 60 days or more past due on, in whole or in part, on any debt obligation within the past 24 months. Additionally, the originator must verify and document that, within the previous 36 months, the borrower was not a debtor in any bankruptcy proceeding, subject to a Federal or State judgment for collection of any unpaid debt or foreclosure, repossession, deed in lieu of foreclosure, or short sale, and has not had any personal property repossessed. These credit history standards are the same as those established for QRMs.

Similar to the safe harbor proposed in §__.15 of the proposed rules for the QRM requirements, the Federal banking agencies are proposing a safe harbor that would allow an originator to satisfy the documentation and verification requirements regarding a borrower's credit history. Under the proposal, an originator of a qualifying automobile loan will be deemed to have complied with the verification and documentation requirements related to the borrower's credit history (as described above) if, no more than 90 days before the automobile loan closing, the originator (1) obtains a credit report regarding the borrower from at least two consumer reporting agencies that compile and maintain files on consumers on a nationwide basis (within the meaning of 15 U.S.C. 1681a(p)); and (2) determines, based on the information in such credit reports, that the borrower meets the credit history requirements related described above. This safe harbor would not be available if the originator obtains a subsequent credit report before the closing of the automobile loan transaction that indicates that the borrower does not meet the credit history requirements.

4. Loan-to-value

Limitations relative to the amount financed are critical for automobile lending because the collateral is subject to such rapid depreciation. Therefore, under the proposed rules, an originator must document that, at the time of the closing of the automobile loan, the borrower tendered a minimum down payment from the borrower's personal funds and trade-in allowance,[178] if any, that is sufficient to pay (1) the full cost of vehicle title, tax, and registration fees, as well as any dealer-imposed fees, and (2) 20 percent of the purchase price of the automobile. Under §__.16 of the proposed rules, the purchase price of a new automobile is the net amount the consumer paid for the vehicle after any manufacturer, dealer, or financing incentive payments or cash rebates are applied. However, for a used automobile, the purchase price is the lesser of either the actual purchase price or the value of the automobile, as determined by a nationally recognized automobile pricing agency (for example, N.A.D.A. or Kelley Blue Book) based on the manufacturer, year, model, features, and condition of the vehicle.

An illustration of how to determine the minimum down payment is provided below.

Down Payment Determination

30,000	Invoice Purchase Price
2,000	Manufacturer Cash Rebate
1,000	Dealer Incentive
27,000	Purchase Price
5,400	20% of Purchase Price
2,700	Tax, Title, and License

[178] Under §__.16 of the proposed rules, a trade-in allowance is the amount a vehicle purchaser is given as a credit at the purchase of a vehicle for the fair exchange of the borrower's existing vehicle to compensate the dealer for some portion of the vehicle purchase price, except that such amount shall not exceed the trade-in value of the used vehicle, as determined by a nationally recognized automobile pricing agency and based on the manufacturer, year, model, features, and condition of the vehicle.

8,100 Down Payment Requirement

$18,900 Maximum Loan Amount

Request for Comment

159(a). Are the proposed requirements for a qualifying automobile loan appropriate? 159(b). Are these standards sufficient and appropriate to ensure that qualifying automobile loans have very low credit risk?

160. Are the DTI ratios employed for measuring a borrower's financial capacity an appropriate standard?

E. Buy-back requirements for ABS issuances collateralized exclusively by qualifying commercial, CRE or automobile loans

Under the proposed rules, for a securitizer to qualify for a zero percent risk retention requirement under §__.18, §__.19 or §__.20, as applicable, the depositor must have (and certify that it has) effective internal supervisory controls with respect to its process for ensuring that all assets that collateralize the ABS meet the applicable underwriting standards set forth in §__.18, §__.19 or §__.20, as applicable, of the proposed rules. The Federal banking agencies recognize that, despite the use of reasonable processes and procedures by a depositor or sponsor, it is possible that one or more loans included in a securitization transaction may later be determined to have not met the underwriting standards set forth in §__.18, §__.19 or §__.20, as applicable, of the proposed rules due to inadvertent error. For example, an originator conducting post-origination file reviews for compliance or internal audit purposes may find that some aspects of the documentation required to verify the borrower's monthly income were not obtained. The Agencies are concerned that if an error that is discovered after closing of the securitization were to make the issuance ineligible for the proposed exemption, then sponsors and investors may well be less willing to participate in securitization transactions that are structured to meet the underwriting standards of §__.18, §__.19 or §__.20, as applicable, of the proposed rules. On the other hand, if there is no penalty for including in a securitization transaction a loan that does not meet such underwriting standards, sponsors and other participants in the securitization may not have the proper incentives to ensure that the issuance is collateralized exclusively by qualifying commercial, CRE, or automobile loans.

The proposal seeks to balance these interests by providing that a sponsor that has relied on an exemption from the retention requirement under §__.18, §__.19 or §__.20, as applicable, of the proposed rules would not lose the exemption, if, after closing of the securitization transaction, it is determined that one or more of the loans collateralizing the ABS do not meet all of the applicable criteria under §__.18, §__.19 or §__.20, as applicable, of the proposed rules provided that:

(a) The depositor certified the effectiveness of its internal supervisory controls for ensuring all of the loans backing the ABS are qualified loans under §__.18, §__.19 or §__.20, as applicable, of the proposed rules; .

(b) The sponsor repurchases the loan(s) determined to not meet the underwriting standards set forth in §__.18, §__.19 or §__.20, as applicable, of the proposed rules from the issuing entity at a price at least equal to the remaining principal balance and accrued interest on the loan(s) no later than ninety (90) days after the determination that the loans do not satisfy the underwriting standards set forth in §__.18, §__.19 or §__.20, as applicable, of the proposed rules; and

(c) The sponsor discloses to the investors of the ABS any loan(s) that are repurchased by the sponsor, including the principal amount of such repurchased loan(s) and the cause for such repurchase.

These conditions, which are identical to those applicable to QRMs, are intended to provide the sponsor with the opportunity to correct inadvertent errors by repurchasing any non-qualified loan(s) and removing such non-qualifying loan(s) from the ABS, while protecting investors. Moreover, in light of the buy-back requirement, sponsors should continue to have a strong economic incentive to ensure that all loans backing a securitization subject to zero risk retention under §__.18, §__.19 or §__.20, as applicable, of the proposed rules satisfy all of the conditions applicable to such loans under §__.18, §__.19 or §__.20, as applicable, of the proposed rules.

Request for Comment

161(a). The Agencies seek comment on whether the sponsor should be required to repurchase the entire pool of loans collateralizing the ABS if the amount or percentage of the loans that are required to be repurchased due to the failure to meet the underwriting standards under §__.18, §__.19 or §__.20, as applicable, of the proposed rules reaches a certain threshold. 161(b). If so, what threshold would be appropriate?

VI. General Exemptions

Section 15G(c)(1)(G) and section 15G(e) of the Exchange Act require the Agencies to provide a total or partial exemption from the risk retention requirements for certain types of ABS or securitization transactions. In addition, section 15G(e)(1) permits the Federal banking agencies and the Commission jointly to adopt or issue additional exemptions, exceptions, or adjustments to the risk retention requirements of the rules, including exemptions, exceptions, or adjustments for classes of institutions or assets, if the exemption, exception, or adjustment would: (A) help ensure high quality underwriting standards for the securitizers and originators of assets that are securitized or available for securitization; and (B) encourage appropriate risk management practices by the securitizers and originators of assets, improve the access of consumers and businesses to credit on reasonable terms, or otherwise be in the public interest and for the protection of investors.[179]

Consistent with these provisions, section ___.21 of the proposed rules exempts certain types of ABS or securitization transactions from the credit risk retention requirements of the rule. Certain of these exemptions would appear in the rules of all Agencies, and others would appear only in the rules of certain Agencies, reflecting the different scope of the Agencies' rulewriting authority.

A. Exemption for federally insured or guaranteed residential, multifamily, and health care mortgage loan assets

Proposed § ___.21(a)(1) would implement section 15G(e)(3)(B) of the Exchange Act, which exempts from the risk retention requirements any residential, multifamily, or health care facility mortgage loan asset, or securitization based directly or indirectly on such an asset, that is insured or guaranteed by the United States or an agency of the United States.[180] Section 15G expressly clarifies that Fannie Mae, Freddie Mac, and the Federal Home Loan Banks are not agencies of the United States,[181] and the proposed

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[179] See 15 U.S.C. § 78o-11(e)(1) and (2).

[180] See 15 U.S.C. 78o-11(e)(3)(B).

[181] See 15 U.S.C. 78o-11(c)(1)(G)(ii), (e)(3)(B).

rules include a specific provision making clear that the exemptions that apply to ABS that is issued, guaranteed or insured by a U.S. government agency or that is backed by loans insured or guaranteed by a U.S. government agency do not apply where the issuer, insurer or guarantor is Fannie Mae, Freddie Mac, or a Federal Home Loan Bank.[182]

Proposed § ___.21(a)(1)(i) would exempt any securitization transaction that is collateralized solely (excluding cash and cash equivalents) by residential, multifamily, or health care facility mortgage loan assets if the assets are insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United States. Currently, the federal government insures or guarantees residential, multifamily, and healthcare facility loans through a variety of programs. Some examples include FHA insurance on single family mortgage loans which insures the lender at approximately 100 percent of losses including advanced taxes, insurance and foreclosure costs. The Department of Veterans Administration also guarantees between 25 percent and 50 percent of lender losses in the event of residential borrower defaults. United States Department of Agriculture Rural Development also guarantees a sliding amount against loss of up to 90 percent of the original loan amount for single family loans. Each of the agencies sets underwriting and servicing standards, and in the case of some multifamily programs underwrites the mortgage itself. The agencies charge a fee or premium for the insurance/guaranty, and monitor the performance of participating lenders and borrowers.

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[182] See section 15 U.S.C. 78o-11(c)(1)(G) and (e)(3)(B) and the proposed rules at § __.21(c). At this time, the Federal Home Loan Banks do not, and are not authorized to, issue or guarantee asset-backed securities. Similarly, neither Fannie Mae, Freddie Mac, nor the Federal Home Loan Banks insure or guarantee individual loans, and none is authorized to do so. These references are included in § ___.21(c) in order to conform the rule of construction to that which is required by section 15G(e)(3) of the Exchange Act.

Proposed § ___.21(a)(1)(ii) would exempt any securitization transaction that involves the issuance of ABS if the ABS are insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United States and that are collateralized solely (excluding cash and cash equivalents) by residential, multifamily, or health care facility mortgage loan assets, or interests in such assets. Thus, proposed § __.21(a)(1)(ii) would exempt ABS the payment of principal and interest on which is guaranteed by the United States or an agency of the United States and that is collateralized by ABS that itself is backed by residential, multifamily, or health care facility mortgage loan assets. Examples of securitization transactions that would be exempted under § __.21(a)(1)(ii) include securities guaranteed by the Government National Mortgage Association (Ginnie Mae). Ginnie Mae guarantees the issuance of securities by approved lender/issuers. These mortgage-backed securities (MBS) are collateralized solely by federally insured or guaranteed loans. The insurance or guarantee protects the lender from some or all of the credit loss on the loan in the event of a borrower default. Upon issuance of the security, the issuer is obligated to advance from its own funds principal and interest to the investors if the borrower fails to pays the mortgage. Ginnie Mae guarantees to the investors that, in the event the issuer defaults on this obligation, Ginnie Mae will ensure the investors are paid. Ginnie Mae provides a similar guarantee for Real Estate Mortgage Investment Conduits (REMICs) and Platinum Securities, which are collateralized by Ginnie Mae MBS.

Although, historically, federally insured/guaranteed loans have been securitized largely through Ginnie Mae, and Ginnie Mae is statutorily restricted to guaranteeing only securities collateralized by federally insured/guaranteed loans, this regulation would exempt a private securitization from risk retention to the extent it is collateralized solely by loans with federal insurance or guarantees. In addition, in cases where private securitization may be used the proposed rules do not limit the exemption based on the federal housing program involved or the nature of the government's insurance or guaranty coverage.

Request for Comments

162(a). Have the Agencies appropriately implemented the exemption in section 15G(e)(3)(B) of the Exchange Act? 162(b). Why or why not?

163. Are we correct in believing the federal department or agency issuing, insuring, or guaranteeing the ABS or collateral will monitor the quality of the assets securitized?

164(a). While it appears that Congress may have intended to exempt all existing federal insurance or guarantee programs for residential, multifamily, or health care facility mortgage loans, comments are requested on the proposed rules where private securitization may be used in the following areas. Are there risks in exempting assets or ABS that are not significantly insured or guaranteed by a federal agency? 164(b). If so, what level of federal guarantee or insurance should be required? 164(c). Would inclusion of additional requirements be appropriate in the public interest and for the protection of investors? 164(d). Why or why not? 164(e). Would inclusion of additional requirements be disruptive to any federal guarantee or insurance programs established or authorized by Congress? 164(f). If so, how and to what extent?

B. Other exemptions

Section 15G(c)(1)(G)(ii) of the Exchange Act separately requires the rules of the Agencies to provide for a total or partial exemption from risk retention requirements for securitizations of assets that are issued or guaranteed by the United States or an agency of the United States as the Federal banking agencies and the Commission jointly determine appropriate in the public interest and the protection of investors.[183] This exemptive authority is broader than the statutory exemption in section 15G(e)(3)(B) because it permits the exemption of any securitization of assets that are issued or guaranteed by the United States or any agency of the United States (and not just those based on residential, multifamily, or health care facility mortgage loan assets). Proposed § __.21(b)(1) fully exempts any securitization transaction if the asset-backed securities issued in the transaction are (i) collateralized solely (excluding cash and cash equivalents) by obligations issued by the United States or an agency of the United States; (ii) collateralized solely (excluding cash and cash equivalents) by assets that are fully insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United States (other than those referred to in paragraph (a)(1)(i) of this section);[184] or (iii) fully guaranteed as to the timely payment of principal and interest by the United States or any agency of the United States.. This exemption is being proposed because payments of principal and interest on the ABS, or on the collateral backing the ABS, would be backed by the United States or an agency of the United States and, thus,

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[183] See 15 U.S.C. 78o-11(c)(1)(G).

[184] To avoid confusion, the proposed rules provide that these assets do not include the types of federally insured or guaranteed residential, mortgage, and health care mortgage loan assets that are covered by the exemption in proposed § __.21(a).

the exemption should be appropriate in the public interest and for the protection of investors. The federal department or agency issuing, insuring or guaranteeing the ABS or collateral would monitor the quality of the assets securitized, consistent with the relevant statutory authority.[185]

Proposed § __.21(a)(2) provides an exemption from the risk retention requirements of the rules for any securitization transaction that is collateralized solely (excluding cash and cash equivalents) by loans or other assets made, insured, guaranteed, or purchased by any institution that is subject to the supervision of the Farm Credit Administration, including the Federal Agricultural Mortgage Corporation. This provision implements the exemption for these types of assets included in section 15G(e)(3)(A) of the Exchange Act.[186]

Section 15G(c)(1)(G)(iii) requires that the rules of the Agencies provide a total or partial exemption for an ABS if the security is (i) issued or guaranteed by any State of the United States, or by any political subdivision of a State or territory, or by any public instrumentality of a State or territory that is exempt from the registration requirements of the Securities Act by reason of section 3(a)(2) of the Securities Act[187] or (ii) defined as a qualified scholarship funding bond in section 150(d)(2) of the Internal Revenue Code of 1986.[188] In light of the special treatment afforded such securities by Congress, the

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[185] See 12 U.S.C. 78o-11(e)(2).

[186] See 15 U.S.C. 78o-11(e)(3)(A).

[187] 15 U.S.C. 77c(a)(2).

[188] See 26 U.S.C. 150(d)(2). Such bonds are those issued by a not-for-profit corporation established and operated exclusively for the purpose of acquiring student loans incurred under the Higher Education Act of 1965, and organized at the request of a State or a political subdivision of a State. See 10 U.S.C. chapter 28.

directive in section 15G(c)(1)(G)(iii), and the role of the State or municipal entity in issuing, insuring, or guaranteeing the ABS or collateral, the Agencies are proposing to exempt such ABS form the risk retention requirements of the rule as an exemption that is appropriate in the public interest and for the protection of investors.[189]

Request for Comments

165(a). Have the Agencies appropriately implemented the exemption in section 15G(e)(3)(A) of the Exchange Act and the exemptive authority in section 15G(c)(1)(G)(ii) and (iii)? 165(b). Why or why not?

166(a). Is the proposed exemption for ABS issued or guaranteed by a State or municipal entity appropriate? 166(b). Is it under or over-inclusive? 166(c). There may be some ABS in which the sponsor is a municipal entity (i.e., a State or Territory of the United States, the District of Columbia, any political subdivision of any State, Territory or the District of Columbia, or any public instrumentality of one or more States, Territories or the District of Columbia), however, the ABS are issued by a special purpose entity, that is created at the direction of the municipal entity, but are not issued or guaranteed by the municipal entity. Should the rules also exempt from the risk retention requirements asset-backed securities where the sponsor is a municipal entity? 166(d). There are some municipal ABS that are issued by a municipal entity and exempt by reason of Section 3(a)(2) of the Securities Act but may include assets originated using the same underwriting criteria as private label securitizations. Should the rules, as proposed, exempt them?

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[189] See §§ ___.21(a)(3) and (4) of the proposed rules.

167(a). Are there any ABS that are collateralized solely by obligations issued by the United States or an agency of the United States where the process of packaging and securitizing those obligations may raise issues that the risk retention requirement was designed to address? 167(b). For example, would a securitization by a non-governmental securitizer of debt issued by the Tennessee Valley Authority raise any issues such that the Agencies should provide only a partial exemption? 167(c). If so, what type of transactions and how should the Agencies determine the amount and form of risk retention to be required?

C. Exemption for certain resecuritization transactions

Section ___.21(a)(5) of the proposed rules would exempt from the credit risk retention requirements certain resecuritization transactions that meet two conditions.[190] First, the transaction must be collateralized solely by existing ABS issued in a securitization transaction for which credit risk was retained as required under the rule or which was exempted from the credit risk retention requirements of the rule (hereinafter 15G-compliant ABS). Second, the transaction must be structured so that it involves the issuance of only a single class of ABS interests and provides for the pass-through of all principal and interest payments received on the underlying ABS (net of expenses of the issuing entity) to the holders of such class. The holder of a resecuritization ABS structured as a single-class pass-through has a fractional undivided interest in the pool of underlying ABS and in the distributions of principal and interest (including prepayments) from these underlying ABS. Accordingly, the principal and interest payments allocated

[190] In a resecuritization transaction, the asset pool underlying the ABS issued in the transaction comprises one or more asset-backed securities. In this section, we refer to the securities issued in a resecuritization transaction as "resecuritization ABS."

to each holder are identical (less any fees associated with the resecuritization) to those that would occur if that holder were to hold individual securities representing the same fractional interest in each of the underlying ABS.[191] Thus, a resecuritization ABS structured as a single-class pass-through would not alter the level or allocation of credit risk and interest rate risk on the underlying ABS.

The Agencies propose to adopt this exemption under the general exemption provisions of section 15G(e)(1) of the Exchange Act. Under that provision, the Agencies may jointly adopt or issue exemptions, exceptions, or adjustments to the risk retention rules, if such exemption, exception, or adjustment would: (A) help ensure high quality underwriting standards for the securitizers and originators of assets that are securitized or available for securitization; and (B) encourage appropriate risk management practices by the securitizers and originators of assets, improve the access of consumers and businesses to credit on reasonable terms, or otherwise be in the public interest and for the protection of investors.[192] As noted above, all of the ABS underlying a resecuritization that would be exempted under proposed § ___.21(a)(5) would already have been issued in a securitization transaction in which the sponsor has retained credit risk in accordance with the rule, or for which an exemption from the rule was available. Accordingly, the resecuritization of a single-class pass-through would neither increase nor reallocate the

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[191] According to the staff of the FHFA, Fannie Mae Mega Certificates are an example of a single-class pass-through resecuritization. FHFA staff have indicated that these certificates represent a fractional undivided beneficial ownership interest in the pool of underlying ABS (typically MBS, REMICs and other Mega Certificates) and in the principal and interest distributions from those underlying ABS. The proposed exemption in § __.21(a)(5) of the proposed rules would be available to any sponsor of a securitization transaction that is structured in accordance with the rule's requirements.

[192] 15 U.S.C. § 78o-11(e)(1).

credit risk inherent in that underlying 15G-compliant ABS. Furthermore, because this type of resecuritization may be used to combine 15G-compliant ABS backed by smaller asset pools, the exemption for this type of resecuritization could improve the access of consumers and businesses to credit on reasonable terms by allowing for the creation of an additional investment vehicle for these smaller pools. The exemption would allow the creation of ABS that may be backed by more geographically diverse pools than those that can be achieved by the pooling of individual assets as part of the issuance of the underlying 15G-compliant ABS, which could also improve access to credit on reasonable terms.

Under the proposed rules, sponsors of resecuritizations that are not structured purely as single-class pass-through transactions would be required to meet the credit risk retention requirements with respect to such resecuritizations unless another exemption for the resecuritization is available, regardless of whether the sponsor of the initial securitization transaction retained credit risk under the rule or whether an exemption applied to the initial securitization transaction. Thus, resecuritizations that re-tranche the credit risk of the underlying ABS would be subject to separate risk retention requirements under the proposed rules.[193] Similarly, under the proposed rules, resecuritizations that re-

[193] For example, under the proposed rules, the sponsor of a collateralized debt obligation (CDO) would not meet the proposed conditions of the exemption and therefore would be required to retain risk in accordance with the rule with respect to the CDO, regardless of whether the underlying ABS have been drawn exclusively from 15G-compliant ABS. See 15 U.S.C. § 78o-11(c)(1)(F). In a typical CDO transaction, a securitizer pools interests in the mezzanine tranches from many existing ABS and uses that pool to collateralize the CDO. Repayments of principal on the underlying ABS interests are allocated so as to create a senior tranche, as well as supporting mezzanine and equity tranches of increasing credit risk. Specifically, as periodic principal payments on the underlying ABS are received, they are distributed first to the senior tranche of the CDO

tranche the prepayment risk of the underlying ABS, or that are structured to achieve a sequential paydown of tranches, would not be exempted. In these resecuritizations, although losses on the underlying ABS would be allocated to holders in the resecuritization on a pro rata basis, holders of longer duration classes in the resecuritization could be exposed to a higher level of credit risk than holders of shorter duration classes.

Section 15G does not apply to ABS issued before the effective date of the Agencies' final rules.[194] As a practical matter, private-label ABS issued before the effective date of the final rules will typically not be 15G-compliant ABS, because such ABS will not have been structured to meet the rule's risk retention requirements. ABS issued before the effective date that meets the terms of an exemption of the type proposed under __.21 (General exemptions) or __.11 (Fannie Mae and Freddie Mac ABS) could serve as 15G-compliant ABS.

Request for Comment

168(a). Are there other types of resecuritization transactions backed solely by 15G-compliant ABS that should be exempt from the risk retention requirements? 168(b). If so, what principles and factors should the Agencies use in considering whether other types of resecuritizations backed by 15G-compliant ABS should be exempted from the risk retention requirements of section 15G? 168(c). Should the Agencies consider granting an exemption only if it is clear that the resecuritization transaction does not

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and then to the mezzanine and equity tranches in order of increasing credit risk, with any shortfalls being borne by the most subordinate tranche then outstanding.

[194] See 15 U.S.C. § 78o-11(i) (regulations become effective with respect to residential mortgage-backed ABS 1 year after publication of the final rules in the Federal Register, and 2 years for all other ABS).

expose investors in the resecuritization to different levels or types of credit risk in the securitized assets than the underlying 15G-compliant ABS?

169(a). Should the rule provide an exemption for a sequential-pay resecuritization that is collateralized only by 15G-compliant ABS? In this type of resecuritization, the rights to principal repayment of the holders of the different classes differ solely with respect to the timing of such repayments. Longer duration classes receive no payments of principal until shorter duration classes have been paid off in full and principal shortfalls are allocated on a pro-rata basis based upon the unpaid principal balance of each class. As the shorter duration classes are paid off, the unpaid principal balances of the longer duration classes begin to represent a larger portion of the total unpaid principal balances of the underlying ABS and, therefore, the longer duration classes are allocated an ever-increasing percentage of credit losses as the ABS matures. 169(b). If an exemption for sequential-pay resecuritizations backed by 15G-compliant ABS is appropriate, how could such an exemption be written to ensure the exemption is limited to this particular structure?

170(a). Should the Agencies provide an exemption for prepayment-tranched resecuritizations that are backed solely by 15G-compliant ABS? This form of resecuritization involves the sponsor of the resecuritization creating tranches based on the prepayments of the underlying ABS (i.e.., prepayments received by the ABS in the first-level ABS securitization). One type of prepayment-tranched resecuritization is a planned amortization class (PAC) resecuritization. PAC bonds receive principal payments based on the level of prepayments and will have their expected duration if the actual speed of prepayments on the underlying ABS falls within a designated range. In order to create a

PAC bond with greater certainty of cash flow than the underlying ABS, one or more support (SUP) classes that are highly sensitive to varying levels of prepayment are created as part of the same transaction. If the rate of prepayments is faster than that assumed in the creation of the PAC, the SUPs receive more principal in order to prevent an overpayment of principal on the PAC. If the rate of prepayment is slower, principal is redirected from the SUPs in order to achieve the specified repayment schedule on the PAC. In either case, credit losses are allocated on a pro rata basis based on the unpaid principal balance attributable to each class. Accordingly, the effect of faster-than-expected rates of prepayment will tend to expose holders of the PAC bonds to relatively greater losses than the holders of the SUPs, while slower-than-expected rates of prepayment will tend to have the opposite effect. Moreover, in transactions where more than one PAC bond is created, the distribution of principal repayments to the PACs are based on priority and, therefore, the holders of the PACs are exposed to levels of credit risk that differ from that of the underlying ABS. 170(b). If an exemption of prepayment-tranched resecuritizations or certain types of such resecuritizations (such as PAC structures) is appropriate, how could an exemption be written to ensure that the exemption does not extend to other resecuritizations?

171. As noted above, the proposed exemptions require the underlying ABS be 15G-compliant ABS. In practice, initially this may mean that only resecuritizations based on ABS guaranteed by Fannie Mae and Freddie Mac will qualify for this exemption. Does this raise any competitive or other issues and if so, how can they be mitigated without eliminating the requirement there be risk retention on the underlying ABS?

172(a). Is the proposed language for this exemption appropriate? 172(b). Does any portion of the exemption cause an ambiguity that should be addressed?

D. Additional exemptions

Consistent with section15G of the Exchange Act, § __.23(b) of the proposed rules provides that the Federal banking agencies and the Commission, in consultation with FHFA and HUD, may jointly adopt or issue additional exemptions, exceptions or adjustments to the credit risk retention requirements, including exemptions, exceptions or adjustments for classes of institutions or assets in accordance with section 15G(e).[195] In addition, § __.23(a) of the proposed rules recognizes that the Agencies with rulewriting authority under section 15G(b)[196] with respect to the type of assets involved may jointly provide a total or partial exemption of any individual securitization transaction, as such Agencies determine may be appropriate in the public interest and for the protection of investors, as permitted by section 15G(c)(1)(G)(i).[197] The Agencies expect to coordinate with each other to facilitate the processing, review and action on requests for such written interpretations or guidance, or additional exemptions, exceptions or adjustments.

Request for Comments

173(a). Are there securitization transactions that would not be covered by the exemptions in the proposed rules that should be exempted from risk retention requirements pursuant to section 15G(e)(3) of the Exchange Act? 173(b). If so, what are

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[195] 15 U.S.C. § 78o-11(e).

[196] 15 U.S.C. § 78o-11(b).

[197] 15 U.S.C. § 78o-11(c)(1)(G)(i).

the features and characteristics of such securitization transactions that would properly exempt them from risk retention requirements pursuant to section 15G(e)(3)?

E. Safe harbor for certain foreign-related transactions

The proposed rules include a safe harbor provision for certain predominantly foreign transactions based on the limited nature of the transactions' connections with the United States and U.S. investors. The proposed safe harbor is intended solely to provide clarity that the Agencies would not apply the requirements of the proposed rules to transactions that meet all of the conditions of the safe harbor. The proposed safe harbor should not be interpreted as reflecting the views of any Agency as to the potential scope of transactions or persons subject to section 15G or the proposed rules.

As set forth in section ___.23 of the proposed rules, the safe harbor provides that the rule's risk retention requirements would not apply to a securitization transaction if certain conditions are met, including: (i) the securitization transaction is not required to be and is not registered under the Securities Act; (ii) no more than 10 percent of the dollar value by proceeds (or equivalent if sold in a foreign currency) of all classes of ABS interests sold in the securitization transaction are sold to U.S. persons or for the account or benefit of U.S. persons;[198] (iii) neither the sponsor of the securitization transaction nor the issuing entity is (A) chartered, incorporated, or organized under the laws of the U.S.,

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[198] The proposed rules include a definition of "U.S. person" that is substantially the same as the definition of "U.S. person" in the Commission's Regulation S, although Regulation S relates solely to the application of section 5 of the Securities Act (12 U.S.C. § 77e). See proposed rules at § ___.23 and 17 CFR 203.902(k). Additionally, the 10 percent threshold is consistent with other Commission exemptive rules relating to cross-border offerings under which the Commission has provided accommodations for not applying its rules even though there is a limited offering of securities in the United States. See Securities Act Rules 801 and 802 (17 CFR 230.801 and 802).

or a U.S. State or Territory or (B) the unincorporated branch or office located in the U.S. of an entity not chartered, incorporated, or organized under the laws of the U.S., or a U.S. State or Territory (collectively, a U.S.-located entity); (iv) no more than 25 percent of the assets collateralizing the ABS sold in the securitization transaction were acquired by the sponsor, directly or indirectly, from a consolidated affiliate of the sponsor or issuing entity that is a U.S.-located entity.[199]

The safe harbor is intended to exclude from the proposed risk retention requirements transactions in which the effects on U.S. interests are sufficiently remote so as not to significantly impact underwriting standards and risk management practices in the United States or the interests of U.S. investors. Accordingly, the conditions for use of the safe harbor limit involvement by persons in the U.S. with respect to both assets being securitized in a transaction and the ABS sold in connection with the transaction. The safe harbor would not be available for any transaction or series of transactions that, although in technical compliance with the conditions of the safe harbor, is part of a plan or scheme to evade the requirements of section 15G and the proposed rules.

Request for Comment

174(a). Are there any extra or special considerations relating to these circumstances that we should take into account? 174(b). Should the more than 10 percent proceeds trigger be higher or lower (e.g., 0 percent, 5 percent, 15 percent, or 20 percent)?

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[199] See proposed rules at § ____.23.

Appendix A

The tables below show the estimated effects of the proposed QRM standards based on data for all residential mortgage loans purchased or securitized by the Enterprises between 1997 and 2009. The first set of results shows rates of serious delinquency (SDQ), that is, loans that are 90 days or more delinquent, or are in the process of foreclosure. The second set of results shows volume, in dollars of unpaid principal balance (UPB).

Because the data that FHFA routinely receives from the Enterprises does not include all the factors needed to identify QRM eligible loans, the universe of loans within the data set that would qualify as a QRM under the proposed standards was estimated based on four of the most significant QRM elements: (i) product type (i.e. excluding non-owner occupied loans, low or no documentation loans, interest-only or negative amortization loans, loans with balloon payments, and ARM loans that permit payment shocks in excess of the range permitted by the proposed QRM standards); (ii) front-end and back-end DTI ratios; (iii) LTV ratios; and (iv) credit history.

Because of data limitations, proxies were used for certain of these QRM standards. FHFA does not have individual credit items in the data set used for analysis, such as previous bankruptcies or foreclosures involving the borrower, or current or recent borrower delinquencies on other debt obligations. However, borrowers with such credit issues would tend to have much lower credit scores than other borrowers (all else being equal). To proxy the credit history restrictions in the proposed QRM definition, borrowers with FICO scores below 690 were deemed to not satisfy the proposed QRM credit history standards for purposes of the analysis.

In addition, the analysis uses first-lien LTV ratios as a proxy for combined LTV when relevant. The Agencies do not believe that this proxy would produce a large discrepancy for analysis of loans originated before 2002 or after 2007, but it may understate the proposed QRM definition's effects, both on volume and on rates of SDQ, for originations from 2002 to 2007, as second liens were increasingly used during this period. (That is, the proposed QRM definition would likely cause a greater decrease in SDQ rates and loan volumes than estimated through the use of this proxy.)

Other proposed QRM factors may differ somewhat for this analysis. The QRM proposal is based on current FHA definitions of income, and standards for full documentation of income and full appraisals. The data used in this analysis for purposes of estimating whether a loan would meet the DTI and LTV ratios in the proposed QRM standards, however, is based on Enterprise definitions of income, and Enterprise documentation and appraisal requirements that prevailed at the time the loans were originated. While there may be some circumstances in which the different standards and definitions would have led to a different QRM eligibility estimate, the Agencies do not believe that these differences would have a material impact on the analysis. For example, the Enterprises did not always require an interior appraisal in cases where the default risk was judged to be low and the down payment was substantial. While loans originated to these standards would not be QRM eligible under this proposal, it is likely that the QRM standard would induce originators to require full appraisals going forward, and thus cause these loans to be QRM eligible.

For the first set of results concerning SDQ rates, the first column shows the "QRM qualifying" population. This is the SDQ rate for all loans that are estimated as meeting the proposed QRM standards. The last column in the first set of results shows the SDQ rate for all loans purchased or securitized by the Enterprises in that year. Thus, the difference between the first and last column show the cumulative estimated effect of the set of proposed QRM standards on SDQ for that cohort of loans. The intermediate columns show the SDQ rate for the population of loans in the relevant year that are estimated to meet every QRM standard other than the standard(s) indicated at the top of the column. For example, the second column, headed Product Type, shows the estimated effect of allowing low or no documentation loans, interest-only or negative amortization loans, loans with balloon payments, or ARM loans that permit payment shocks in excess of the range permitted by the proposed QRM standards, while still prohibiting loans with credit history (as proxied through the use of credit scores), an LTV ratio, or debt-to-income ratios that would disqualify them for QRM status. These columns show the differences between the base QRM SDQ rate and the higher risk population within each column. The analysis is shown separately for all loans, for purchases, for rate and term refinances, and for cash out refinances.

The second set of results shows the volume of Enterprise mortgages purchased or securitized that are estimated to have met the proposed QRM standards. The last column shows total dollar originations purchased or securitized by the Enterprises for each year. The first column shows the percent of that volume estimated to be QRM eligible. The intermediate columns show the estimated effect on that volume for the population of loans that are estimated to meet the proposed QRM standards other than the one identified at the top of the column. For example, the second column, headed Product Type, shows the estimated effect on the percentage of Enterprise volume that would be

QRM eligible by allowing loans that do not conform to the Product Type standards for QRMs,[200] while still prohibiting loans with a credit history (as proxied by credit scores), an LTV ratio, or debt-to-income ratios that would disqualify the loan for QRM status. These columns show the differences between the base QRM qualifying percentage and the higher risk population.

All Loans

Ever-to-Date Serious Delinquency Rates for QRMs and the Difference in Rates for Mortgages that Do Not Meet One of the Qualification Requirements

Year	QRM	Product Type	PTI/DTI	LTV	FICO	All Loans
1997	0.42%	+0.05%	+0.39%	+0.61%	+3.08%	+2.30%
1998	0.39%	+0.10%	+0.31%	+0.52%	+2.34%	+1.68%
1999	0.44%	+0.13%	+0.34%	+0.78%	+3.12%	+2.31%
2000	0.32%	+0.43%	+0.20%	+0.83%	+2.94%	+2.77%
2001	0.31%	+0.35%	+0.27%	+0.59%	+2.52%	+2.27%
2002	0.33%	+0.41%	+0.32%	+0.73%	+2.34%	+2.09%
2003	0.55%	+0.64%	+0.66%	+1.06%	+2.95%	+2.40%
2004	0.95%	+1.72%	+1.16%	+1.58%	+4.27%	+4.33%
2005	1.86%	+5.30%	+2.36%	+2.31%	+6.46%	+8.13%
2006	2.72%	+7.49%	+3.35%	+3.73%	+7.90%	+13.93%
2007	2.37%	+6.34%	+3.59%	+4.39%	+8.66%	+17.12%
2008	0.68%	+1.48%	+1.64%	+1.68%	+5.15%	+5.94%
2009	0.04%	+0.06%	+0.11%	+0.09%	+0.50%	+0.24%
Total	0.69%	+2.99%	+1.38%	+0.99%	+3.73%	+5.27%

Percent of Total Dollar Volume for QRMs and Mortgages that Do Not Meet One of the Qualification Requirements

Year	QRM	Product Type	PTI/DTI	LTV	FICO	All Loans
1997	20.44%	+3.75%	+13.04%	+13.74%	+5.81%	$ 286,497,878,371
1998	23.29%	+2.17%	+13.30%	+17.10%	+6.24%	$ 691,033,994,509
1999	19.48%	+3.16%	+14.83%	+12.95%	+5.37%	$ 481,450,519,442
2000	16.44%	+3.70%	+17.00%	+8.40%	+4.53%	$ 356,779,731,420

200 That is, low or no documentation loans, interest-only or negative amortization loans, loans with a balloon payment, or ARM loans that permit payment shocks in excess of the range permitted by the proposed QRM standards.

2001	19.37%	+3.01%	+14.33%	+13.11%	+4.62%	$ 1,039,412,013,403
2002	22.37%	+4.28%	+15.35%	+10.72%	+4.62%	$ 1,385,056,256,240
2003	24.57%	+4.55%	+16.68%	+10.02%	+4.98%	$ 1,924,265,340,603
2004	17.03%	+6.35%	+17.68%	+6.25%	+4.34%	$ 937,643,914,289
2005	14.41%	+6.74%	+18.78%	+5.45%	+3.36%	$ 939,069,358,457
2006	11.52%	+7.11%	+17.59%	+3.91%	+2.73%	$ 887,443,942,464
2007	10.72%	+5.44%	+16.14%	+4.95%	+2.24%	$ 1,027,460,511,244
2008	17.39%	+4.64%	+22.01%	+9.22%	+2.12%	$ 793,136,249,487
2009	30.52%	+3.38%	+24.47%	+15.26%	+1.74%	$ 1,176,445,135,548
Total	19.79%	+4.62%	+17.36%	+9.86%	+3.91%	$11,925,694,845,477

<u>Purchase Loans</u>

Ever-to-Date Serious Delinquency Rates for QRMs and the Difference in Rates for Mortgages that Do Not Meet One of the Qualification Requirements

Year	QRM	Product Type	PTI/DTI	LTV	FICO	All Loans
1997	0.42%	+0.03%	+0.36%	+0.80%	+3.13%	+2.44%
1998	0.46%	+0.04%	+0.30%	+0.90%	+2.70%	+2.13%
1999	0.40%	+0.12%	+0.30%	+0.98%	+3.05%	+2.23%
2000	0.29%	+0.38%	+0.17%	+0.83%	+2.51%	+2.29%
2001	0.38%	+0.35%	+0.28%	+0.97%	+2.72%	+2.59%
2002	0.48%	+0.50%	+0.32%	+1.28%	+2.61%	+2.70%
2003	0.93%	+0.72%	+0.78%	+1.84%	+3.29%	+3.50%
2004	1.16%	+1.97%	+1.24%	+2.53%	+3.93%	+4.71%
2005	2.13%	+6.18%	+2.49%	+2.87%	+5.94%	+8.61%
2006	2.76%	+8.69%	+3.28%	+3.29%	+6.78%	+13.63%
2007	2.33%	+6.76%	+3.31%	+4.33%	+6.79%	+16.51%
2008	0.64%	+1.36%	+1.42%	+2.10%	+4.73%	+5.62%
2009	0.07%	+0.09%	+0.09%	+0.07%	+0.63%	+0.23%
Total	1.01%	+3.84%	+1.56%	+1.28%	+3.69%	+6.39%

Percent of Total Dollar Volume for QRMs and Mortgages that Do Not Meet One of the Qualification Requirements

Year	QRM	Product Type	PTI/DTI	LTV	FICO	All Loans
1997	20.74%	+4.40%	+14.02%	+12.11%	+5.55%	$ 171,316,168,314
1998	22.08%	+2.99%	+15.33%	+13.09%	+6.23%	$ 243,827,154,269
1999	19.86%	+4.02%	+17.29%	+10.39%	+4.93%	$ 252,736,885,540

2000	18.17%	+4.21%	+19.37%	+7.56%	+4.45%	$ 259,462,348,244
2001	19.57%	+4.20%	+18.76%	+7.94%	+4.92%	$ 334,671,388,428
2002	18.43%	+5.80%	+18.86%	+6.12%	+4.51%	$ 378,648,800,742
2003	18.03%	+6.81%	+19.38%	+5.32%	+4.42%	$ 428,404,858,343
2004	16.71%	+9.21%	+20.88%	+3.25%	+3.78%	$ 397,943,548,815
2005	15.67%	+10.22%	+22.25%	+2.51%	+2.92%	$ 433,917,427,310
2006	13.57%	+9.37%	+21.75%	+2.02%	+2.48%	$ 459,040,004,449
2007	12.39%	+6.88%	+19.94%	+3.27%	+1.95%	$ 504,879,485,500
2008	17.33%	+6.08%	+26.06%	+6.40%	+1.86%	$ 321,485,446,505
2009	27.06%	+7.02%	+33.83%	+8.18%	+1.89%	$ 225,983,942,704
Total	17.57%	+6.69%	+20.69%	+5.89%	+3.63%	$ 4,412,317,459,162

No Cash-Out Refinancings

Ever-to-Date Serious Delinquency Rates for QRMs and the Difference in Rates for Mortgages that Do Not Meet One of the Qualification Requirements

Year	QRM	Product Type	PTI/DTI	LTV	FICO	All Loans
1997	0.37%	+0.06%	+0.43%	+0.32%	+2.94%	+2.00%
1998	0.33%	+0.11%	+0.27%	+0.36%	+2.15%	+1.41%
1999	0.46%	+0.17%	+0.43%	+0.66%	+3.26%	+2.47%
2000	0.40%	+0.66%	+0.31%	+0.70%	+3.69%	+4.11%
2001	0.27%	+0.32%	+0.24%	+0.50%	+2.21%	+1.97%
2002	0.28%	+0.27%	+0.28%	+0.65%	+2.01%	+1.63%
2003	0.46%	+0.42%	+0.54%	+0.88%	+2.69%	+1.71%
2004	0.77%	+1.01%	+0.97%	+1.25%	+4.09%	+3.36%
2005	1.43%	+3.09%	+1.92%	+1.96%	+6.46%	+6.54%
2006	2.74%	+6.44%	+3.70%	+3.72%	+8.57%	+13.99%
2007	2.86%	+7.94%	+5.20%	+5.39%	+10.27%	+19.45%
2008	0.70%	+1.80%	+1.94%	+1.55%	+5.25%	+5.78%
2009	0.04%	+0.03%	+0.11%	+0.10%	+0.48%	+0.24%
Total	0.44%	+1.65%	+0.90%	+0.82%	+3.11%	+3.47%

Percent of Total Dollar Volume for QRMs and Mortgages that Do Not Meet One of the Qualification Requirements

Year	QRM	Product Type	PTI/DTI	LTV	FICO	All Loans
1997	21.04%	+3.12%	+11.92%	+15.76%	+6.12%	$ 72,883,400,278
1998	25.24%	+1.92%	+12.34%	+18.72%	+6.40%	$ 302,723,323,315
1999	20.34%	+2.44%	+12.42%	+14.98%	+6.23%	$ 140,480,199,806
2000	13.66%	+2.31%	+11.72%	+10.37%	+5.06%	$ 48,878,241,470
2001	22.56%	+2.89%	+13.21%	+15.14%	+4.72%	$ 390,566,245,690
2002	28.69%	+4.46%	+15.27%	+11.65%	+4.90%	$ 584,998,514,202
2003	31.06%	+4.48%	+16.76%	+11.22%	+5.22%	$ 920,098,549,172
2004	22.37%	+5.15%	+16.81%	+8.76%	+5.07%	$ 269,562,391,201
2005	16.42%	+4.93%	+16.06%	+8.46%	+3.82%	$ 169,162,254,192
2006	10.24%	+6.22%	+13.03%	+6.20%	+2.73%	$ 131,792,837,483
2007	9.41%	+5.15%	+12.27%	+6.36%	+2.16%	$ 196,852,210,903
2008	20.16%	+4.61%	+20.18%	+10.87%	+2.06%	$ 231,714,054,542
2009	32.80%	+3.01%	+22.10%	+16.44%	+1.63%	$ 637,544,819,174
Total	25.50%	+3.95%	+16.25%	+12.53%	+4.23%	$ 4,097,257,041,427

Cash-Out Refinancings

Ever-to-Date Serious Delinquency Rates for QRMs and the Difference in Rates for Mortgages that Do Not Meet One of the Qualification Requirements

Year	QRM	Product Type	PTI/DTI	LTV	FICO	All Loans
1997	0.51%	+0.18%	+0.48%	+0.54%	+3.12%	+2.20%
1998	0.39%	+0.20%	+0.37%	+0.42%	+2.09%	+1.44%
1999	0.52%	+0.23%	+0.42%	+0.56%	+3.05%	+2.27%
2000	0.51%	+0.70%	+0.41%	+0.81%	+4.26%	+3.88%
2001	0.31%	+0.33%	+0.23%	+0.52%	+2.67%	+2.30%
2002	0.31%	+0.40%	+0.28%	+0.61%	+2.57%	+2.15%

2003	0.51%	+0.64%	+0.60%	+1.12%	+3.11%	+2.57%
2004	0.89%	+1.29%	+1.08%	+1.51%	+4.92%	+4.71%
2005	1.70%	+2.71%	+2.22%	+2.55%	+7.11%	+8.34%
2006	2.61%	+3.77%	+3.34%	+4.05%	+9.06%	+14.42%
2007	2.14%	+3.46%	+3.37%	+3.84%	+9.99%	+16.66%
2008	0.72%	+1.39%	+1.73%	+1.44%	+5.47%	+6.52%
2009	0.03%	+0.05%	+0.10%	+0.07%	+0.44%	+0.24%
Total	0.70%	+2.01%	+1.40%	+1.12%	+4.50%	+5.85%

Percent of Total Dollar Volume for QRMs and Mortgages that Do Not Meet One of the Qualification Requirements

Year	QRM	Product Type	PTI/DTI	LTV	FICO	All Loans
1997	18.17%	+2.23%	+10.98%	+16.86%	+6.32%	$ 42,298,309,778
1998	21.25%	+1.30%	+11.88%	+20.45%	+5.91%	$ 144,483,516,925
1999	17.05%	+1.84%	+11.63%	+17.04%	+5.28%	$ 88,233,434,096
2000	10.03%	+2.40%	+9.66%	+10.90%	+4.46%	$ 48,439,141,706
2001	15.19%	+1.90%	+11.01%	+16.10%	+4.18%	$ 314,174,379,286
2002	17.13%	+2.67%	+12.30%	+13.58%	+4.33%	$ 421,408,941,296
2003	19.05%	+2.99%	+14.53%	+11.60%	+5.00%	$ 575,761,933,088
2004	12.16%	+3.34%	+13.83%	+8.15%	+4.43%	$ 270,137,974,274
2005	11.77%	+3.14%	+15.67%	+7.74%	+3.71%	$ 335,989,676,955
2006	8.93%	+4.00%	+13.17%	+5.81%	+3.12%	$ 296,611,100,532
2007	8.93%	+3.39%	+12.61%	+6.70%	+2.75%	$ 325,728,814,842
2008	14.78%	+2.75%	+18.34%	+11.41%	+2.52%	$ 239,936,748,440
2009	28.36%	+1.52%	+22.56%	+17.99%	+1.87%	$ 312,916,373,670
Total	15.81%	+2.75%	+14.39%	+11.78%	+3.89%	$ 3,416,120,344,887

VII. Solicitation of Comments on Use of Plain Language

Section 722 of the Gramm-Leach-Bliley Act, Pub. L. 106-102, sec. 722, 113 Stat. 1338, 1471 (Nov. 12, 1999), requires the Federal banking agencies to use plain language in all proposed and final rules published after January 1, 2000. The Federal banking agencies invite your comments on how to make this proposal easier to understand. For example:

• Have we organized the material to suit your needs? If not, how could this material be better organized?

• Are the requirements in the proposed regulation clearly stated? If not, how could the regulation be more clearly stated?

• Does the proposed regulation contain language or jargon that is not clear? If so, which language requires clarification?

• Would a different format (grouping and order of sections, use of headings, paragraphing) make the regulation easier to understand? If so, what changes to the format would make the regulation easier to understand?

• What else could we do to make the regulation easier to understand?

VIII. ADMINISTRATIVE LAW MATTERS

A. Regulatory Flexibility Act

OCC: The Regulatory Flexibility Act (RFA) generally requires that, in connection with a notice of proposed rulemaking, an agency prepare and make available for public comment an initial regulatory flexibility analysis that describes the impact of a proposed rule on small entities.[201] However, the regulatory flexibility analysis otherwise

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[201] See 5 U.S.C. 601 et seq.

required under the RFA is not required if an agency certifies that the rule will not have a significant economic impact on a substantial number of small entities (defined in regulations promulgated by the Small Business Administration to include banking organizations with total assets of less than or equal to $175 million) and publishes its certification and a short, explanatory statement in the Federal Register together with the rule.

As of September 30, 2010, there were approximately 590 small national banks. For the reasons provided below, the OCC certifies that the proposed rule, if adopted in final form, would not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not required.

As discussed in the "Supplementary Information" above, section 941 of the Dodd-Frank Act[202] generally requires the Federal banking agencies and the Commission, and, in the case of the securitization of any residential mortgage asset, together with HUD and FHFA, to jointly prescribe regulations, that (i) require a securitizer to retain not less than 5 percent of the credit risk of any asset that the securitizer, through the issuance of an asset-backed security (ABS), transfers, sells, or conveys to a third party; and (ii) prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain under section 15G. Although the proposed rule would apply directly only to securitizers, subject to a certain considerations, section 15G authorizes the Agencies to permit securitizers to allocate at least a portion of the risk retention requirement to the originator(s) of the securitized assets.

[202] Codified at section 15G of the Exchange Act, 17 U.S.C. 78o-11

Section 15G provides a total exemption from the risk retention requirements for securitizers of certain securitization transactions, such as an ABS issuance collateralized exclusively by "qualified residential mortgage" (QRM) loans, and further authorizes the Agencies to establish a lower risk retention requirement for securitizers of ABS issuances collateralized by other asset types, such as commercial, commercial real estate (CRE), and automobile loans, which satisfy underwriting standards established by the Federal banking agencies.

The risk retention requirements of section 15G apply generally to a "securitizer" of ABS, where securitizer is defined to mean (i) an issuer of an ABS; or (ii) a person who organizes and initiates an asset-backed transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer. Section 15G also defines an "originator" as a person who (i) through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security; and (ii) sells an asset directly or indirectly to a securitizer.

The proposed rule implements the credit risk retention requirements of section 15G. Section 15G requires the Agencies to establish risk retention requirements for "securitizers". The proposal would, as a general matter, require that a "sponsor" of a securitization transaction retain the credit risk of the securitized assets in the form and amount required by the proposed rule. The Agencies believe that imposing the risk retention requirement on the sponsor of the ABS—as permitted by section 15G—is appropriate in light of the active and direct role that a sponsor typically has in arranging a securitization transaction and selecting the assets to be securitized. The OCC is aware of only six small banking organizations that currently sponsor securitizations (one of which is a national bank, two are state member banks, and three are state nonmember banks based on September 30, 2010 information) and, therefore, the risk retention requirements of the proposed rule, as generally applicable to sponsors, would not have a significant economic impact on a substantial number of small national banks.

Under the proposed rule a sponsor may offset the risk retention requirement by the amount of any vertical risk retention ABS interests or eligible horizontal residual interest acquired by an originator of one or more securitized assets if certain requirements are satisfied, including, the originator must originate at least 20 percent of the securitized assets, as measured by the aggregate unpaid principal balance of the asset pool. In determining whether the allocation provisions of the proposal would have a significant economic impact on a substantial number of small banking organizations, the Federal banking agencies reviewed September 30, 2010 Call Report data to evaluate the securitization activity and approximate the number of small banking organizations that potentially could retain credit risk under allocation provisions of the proposal.[203]

The Call Report data indicates that approximately 329 small banking organizations, 54 of which are national banks, originate loans for securitization, namely ABS issuances collateralized by one-to-four family residential mortgages. The majority of these originators sell their loans either to Fannie Mae or Freddie Mac, which retain credit risk through agency guarantees and would not be able to allocate credit risk to

[203] Call Report Schedule RC-S provides information on the servicing, securitization, and asset sale activities of banking organizations. For purposes of the RFA analysis, the Agencies gathered and evaluated data regarding (1) net securitization income, (2) the outstanding principal balance of assets sold and securitized by the reporting entity with servicing retained or with recourse or other seller-provided credit enhancements, and (3) assets sold with recourse or other seller-provided credit enhancements and not securitized by the reporting bank.

originators under this proposed rule. Additionally, based on publicly-available market data, it appears that most residential mortgage-backed securities offerings are collateralized by a pool of mortgages with an unpaid aggregate principal balance of at least $500 million.[204] Accordingly, under the proposed rule a sponsor could potentially allocate a portion of the risk retention requirement to a small banking organization only if such organization originated at least 20 percent ($100 million) of the securitized mortgages. As of September 30, 2010, only one small banking organization reported an outstanding principal balance of assets sold and securitized of $100 million or more.[205]

The OCC seeks comments on whether the proposed rule, if adopted in final form, would impose undue burdens, or have unintended consequences for, small national banks and whether there are ways such potential burdens or consequences could be minimized in a manner consistent with section 15G of the Exchange Act.

Board: The Regulatory Flexibility Act (5 U.S.C. § 603(b)) generally requires that, in connection with a notice of proposed rulemaking, an agency prepare and make available for public comment an initial regulatory flexibility analysis that describes the impact of a proposed rule on small entities.[206] Under regulations promulgated by the

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[204] Based on the data provided in Table 1, page 29 of the Board's "Report to the Congress on Risk Retention", it appears that the average MBS issuance is collateralized by a pool of approximately $620 million in mortgage loans (for prime MBS issuances) or approximately $690 million in mortgage loans (for subprime MBS issuances). For purposes of the RFA analysis, the agencies used an average asset pool size $500 million to account for reductions in mortgage securitization activity following 2007, and to add an element of conservatism to the analysis.

[205] The OCC notes that this finding assumes that no portion of the assets originated by small banking organizations were sold to securitizations that qualify for an exemption from the risk retention requirements under the proposed rule.

[206] See 5 U.S.C. 601 et seq.

Small Business Administration, a small entity includes a commercial bank or bank holding company with assets of $175 million or less (each, a small banking organization).[207] The Board has considered the potential impact of the proposed rules on small banking organizations supervised by the Board in accordance with the Regulatory Flexibility Act.

For the reasons discussed in Part II of this Supplementary Information, the proposed rules define a securitizer as a "sponsor" in a manner consistent with the definition of that term in the Commission's Regulation AB and provide that the sponsor of a securitization transaction is generally responsible for complying with the risk retention requirements established under section 15G. The Board is unaware of any small banking organization under the supervision of the Board that has acted as a sponsor of an ABS transaction[208] (based on September 30, 2010 data).[209] As of September 30, 2010, there were approximately 2861 small banking organizations supervised by the Board, which includes 2412 bank holding companies, 398 state member banks, 9 Edge and agreement corporations and 42 U.S. offices of foreign banking organizations.

The proposed rules permit, but do not require, a sponsor to allocate a portion of its risk retention requirement to one or more originators of the securitized assets, subject to certain conditions being met. In particular, a sponsor may offset the risk retention

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[207] 13 CFR 121.201.

[208] For purposes of the proposed rules, this would include a small bank holding company; state member bank; Edge corporation; agreement corporation; foreign banking organization; and any subsidiary of the foregoing.

[209] Call Report Schedule RC-S; Data based on the Reporting Form FR 2866b; Structure Data for the U.S. Offices of Foreign Banking Organizations; and Aggregate Data on Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks based on the quarterly form FFIEC 002.

requirement by the amount of any vertical risk retention ABS interests or eligible horizontal residual interest acquired by an originator of one or more securitized assets if certain requirements are satisfied, including, the originator must originate at least 20 percent of the securitized assets, as measured by the aggregate unpaid principal balance of the asset pool. A sponsor using this risk retention option remains responsible for ensuring that the originator has satisfied the risk retention requirements. In light of this option, the Board has considered the impact of the proposed rules on originators that are small banking organizations.

The September 30, 2010 regulatory report data[210] indicates that approximately 329 small banking organizations, 37 of which are small banking organizations that are supervised by the Board, originate loans for securitization, namely ABS issuances collateralized by one-to-four family residential mortgages. The majority of these originators sell their loans either to Fannie Mae or Freddie Mac, which retain credit risk through agency guarantees and would not be able to allocate credit risk to originators under this proposed rule. Additionally, based on publicly-available market data, it appears that most residential mortgage-backed securities offerings are collateralized by a pool of mortgages with an unpaid aggregate principal balance of at least $500 million.[211]

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[210] Call Report Schedule RC-S provides information on the servicing, securitization, and asset sale activities of banking organizations. For purposes of the RFA analysis, the Agencies gathered and evaluated data regarding (1) net securitization income, (2) the outstanding principal balance of assets sold and securitized by the reporting entity with servicing retained or with recourse or other seller-provided credit enhancements, and (3) assets sold with recourse or other seller-provided credit enhancements and not securitized by the reporting bank.

[211] Based on the data provided in Table 1, page 29 of the Board's "Report to the Congress on Risk Retention", it appears that the average MBS issuance is collateralized by a pool of approximately $620 million in mortgage loans (for prime MBS issuances) or

Accordingly, under the proposed rule a sponsor could potentially allocate a portion of the risk retention requirement to a small banking organization only if such organization originated at least 20 percent ($100 million) of the securitized mortgages. As of September 30, 2010, only one small banking organization supervised by the Board reported an outstanding principal balance of assets sold and securitized of $100 million or more.[212]

In light of the foregoing, the proposed rules would not appear to have a significant economic impact on sponsors or originators supervised by the Board. The Board seeks comment on whether the proposed rules would impose undue burdens on, or have unintended consequences for, small banking organizations, and whether there are ways such potential burdens or consequences could be minimized in a manner consistent with section 15G of the Exchange Act.

<u>FDIC:</u> The Regulatory Flexibility Act (RFA) generally requires that, in connection with a notice of proposed rulemaking, an agency prepare and make available for public comment an initial regulatory flexibility analysis that describes the impact of a proposed rule on small entities.[213] However, a regulatory flexibility analysis is not required if the agency certifies that the rule will not have a significant economic impact on a substantial number of small entities (defined in regulations promulgated by the

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approximately $690 million in mortgage loans (for subprime MBS issuances). For purposes of the RFA analysis, the agencies used an average asset pool size $500 million to account for reductions in mortgage securitization activity following 2007, and to add an element of conservatism to the analysis.

212 The FDIC notes that this finding assumes that no portion of the assets originated by small banking organizations were sold to securitizations that qualify for an exemption from the risk retention requirements under the proposed rule.

213 <u>See</u> 5 U.S.C. 601 <u>et seq</u>.

Small Business Administration to include banking organizations with total assets of less than or equal to $175 million) and publishes its certification and a short, explanatory statement in the Federal Register together with the rule.

As of September 30, 2010, there were approximately 2,768 small FDIC-supervised institutions, which includes 2,639 state nonmember banks and 129 state chartered savings banks. For the reasons provided below, the FDIC certifies that the proposed rule, if adopted in final form, would not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not required.

As discussed in the "Supplementary Information" above, section 941 of the Dodd-Frank Act[214] generally requires the Federal banking agencies and the Commission, and, in the case of the securitization of any residential mortgage asset, together with HUD and FHFA, to jointly prescribe regulations, that (i) require a securitizer to retain not less than 5 percent of the credit risk of any asset that the securitizer, through the issuance of an asset-backed security (ABS), transfers, sells, or conveys to a third party; and (ii) prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain under section 15G. Although the proposed rule would apply directly only to securitizers, subject to a certain considerations, section 15G authorizes the Agencies to permit securitizers to allocate at least a portion of the risk retention requirement to the originator(s) of the securitized assets.

Section 15G provides a total exemption from the risk retention requirements for securitizers of certain securitization transactions, such as an ABS issuance collateralized

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[214] Codified at section 15G of the Exchange Act, 17 U.S.C. 78o-11.

exclusively by "qualified residential mortgage" (QRM) loans, and further authorizes the Agencies to establish a lower risk retention requirement for securitizers of ABS issuances collateralized by other asset types, such as commercial, commercial real estate (CRE), and automobile loans, which satisfy underwriting standards established by the Federal banking agencies.

The risk retention requirements of section 15G apply generally to a "securitizer" of ABS, where securitizer is defined to mean (i) an issuer of an ABS; or (ii) a person who organizes and initiates an asset-backed transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer. Section 15G also defines an "originator" as a person who (i) through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security; and (ii) sells an asset directly or indirectly to a securitizer.

The proposed rule implements the credit risk retention requirements of section 15G. The proposal would, as a general matter, require that a "sponsor" of a securitization transaction retain the credit risk of the securitized assets in the form and amount required by the proposed rule. The Agencies believe that imposing the risk retention requirement on the sponsor of the ABS—as permitted by section 15G—is appropriate in view of the active and direct role that a sponsor typically has in arranging a securitization transaction and selecting the assets to be securitized. The FDIC is aware of only six small banking organizations that currently sponsor securitizations (one of which is a national bank, two are state member banks, and three are state nonmember banks based on September 30, 2010 information) and, therefore, the risk retention requirements of the proposed rule, as generally applicable to sponsors, would not have a significant economic impact on a substantial number of small state nonmember banks.

Under the proposed rule a sponsor may offset the risk retention requirement by the amount of any vertical risk retention ABS interests or eligible horizontal residual interest acquired by an originator of one or more securitized assets if certain requirements are satisfied, including, the originator must originate at least 20 percent of the securitized assets, as measured by the aggregate unpaid principal balance of the asset pool. In determining whether the allocation provisions of the proposal would have a significant economic impact on a substantial number of small banking organizations, the Federal banking agencies reviewed September 30, 2010 Call Report data to evaluate the securitization activity and approximate the number of small banking organizations that potentially could retain credit risk under allocation provisions of the proposal.[215]

The Call Report data indicates that approximately 329 small banking organizations, 241 of which are state nonmember banks, originate loans for securitization, namely ABS issuances collateralized by one-to-four family residential mortgages. The majority of these originators sell their loans either to Fannie Mae or Freddie Mac, which retain credit risk through agency guarantees, and therefore would not be allocated credit risk under the proposed rule. Additionally, based on publicly-available market data, it appears that most residential mortgage-backed securities

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[215] Call Report Schedule RC-S provides information on the servicing, securitization, and asset sale activities of banking organizations. For purposes of the RFA analysis, the Agencies gathered and evaluated data regarding (1) net securitization income, (2) the outstanding principal balance of assets sold and securitized by the reporting entity with servicing retained or with recourse or other seller-provided credit enhancements, and (3) assets sold with recourse or other seller-provided credit enhancements and not securitized by the reporting bank.

offerings are collateralized by a pool of mortgages with an unpaid aggregate principal balance of at least $500 million.[216] Accordingly, under the proposed rule a sponsor could potentially allocate a portion of the risk retention requirement to a small banking organization only if such organization originated at least 20 percent ($100 million) of the securitized mortgages. As of September 30, 2010, only one small banking organization reported an outstanding principal balance of assets sold and securitized of $100 million or more.[217]

The FDIC seeks comment on whether the proposed rule, if adopted in final form, would impose undue burdens, or have unintended consequences for, small state nonmember banks and whether there are ways such potential burdens or consequences could be minimized in a manner consistent with section 15G of the Exchange Act.

SEC: The Commission hereby certifies, pursuant to 5 U.S.C. 605(b), that the proposed rule, if adopted, would not have a significant economic impact on a substantial number of small entities. The proposed rule implements the risk retention requirements of section 15G of the Exchange Act, which, in general, requires the securitizer of a asset-backed securities (ABS) to retain not less than five percent of the credit risk of the assets

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[216] Based on the data provided in Table 1, page 29 of the Board's "Report to the Congress on Risk Retention", it appears that the average MBS issuance is collateralized by a pool of approximately $620 million in mortgage loans (for prime MBS issuances) or approximately $690 million in mortgage loans (for subprime MBS issuances). For purposes of the RFA analysis, the agencies used an average asset pool size $500 million to account for reductions in mortgage securitization activity following 2007, and to add an element of conservatism to the analysis.

[217] The FDIC notes that this finding assumes that no portion of the assets originated by small banking organizations were sold to securitizations that qualify for an exemption from the risk retention requirements under the proposed rule.

collateralizing the ABS.[218] Under the proposed rule, the risk retention requirements would apply to "sponsors", as defined in the proposed rule. Based on our data, we found only one sponsor that would meet the definition of a small broker-dealer for purposes of the Regulatory Flexibility Act.[219] Accordingly, the Commission does not believe that the proposed rule, if adopted, would not have a significant economic impact on a substantial number of small entities.

FHFA: Pursuant to section 605(b) of the Regulatory Flexibility Act, FHFA hereby certifies that the proposed rule will not have a significant economic impact on a substantial number of small entities.

B. Paperwork Reduction Act

1. Request for Comment on Proposed Information Collection

Certain provisions of the proposed rule contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA"), 44 U.S.C. 3501-3521. In accordance with the requirements of the PRA, the Agencies may not conduct or sponsor, and the respondent is not required to respond to, an information collection unless it displays a currently valid Office of Management and Budget (OMB) control number. The information collection requirements contained in this joint notice of proposed rulemaking have been submitted by the FDIC, OCC, and the Commission to OMB for approval under section 3506 of the PRA and section 1320.11 of OMB's implementing regulations (5 CFR part 1320). The Board reviewed the proposed rule under the authority delegated to the Board by OMB.

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[218] See 17 U.S.C. 78o-11.

[219] 5 U.S.C. 601 et seq.

Comments are invited on:

(a) Whether the collections of information are necessary for the proper performance of the agencies' functions, including whether the information has practical utility;

(b) The accuracy of the estimates of the burden of the information collections, including the validity of the methodology and assumptions used;

(c) Ways to enhance the quality, utility, and clarity of the information to be collected;

(d) Ways to minimize the burden of the information collections on respondents, including through the use of automated collection techniques or other forms of information technology; and

(e) Estimates of capital or start up costs and costs of operation, maintenance, and purchase of services to provide information.

All comments will become a matter of public record. Commenters may submit comments on aspects of this notice that may affect disclosure requirements and burden estimates at the addresses listed in the ADDRESSES section of this Supplementary Information. A copy of the comments may also be submitted to the OMB desk officer for the agencies: By mail to U.S. Office of Management and Budget, 725 17th Street, NW, #10235, Washington, DC 20503 or by facsimile to 202-395-6974, Attention, Commission and Federal Banking Agency Desk Officer.

2. Proposed Information Collection

Title of Information Collection: Credit Risk Retention.

Frequency of response: Event generated.

Affected Public:[220]

FDIC: Insured state non-member banks, insured state branches of foreign banks, and certain subsidiaries of these entities.

OCC: National banks, Federal savings associations, Federal branches or agencies of foreign banks, or any operating subsidiary thereof.

Board: FDIC-insured state member banks. For §__.15(d)(13) the Board's respondents also include bank holding companies, foreign banking organizations, Edge or agreement corporations, any nonbank financial company (as defined in §__.1(c)(5)), savings and loan holding companies, (as defined in 12 U.S.C. 1467a, on and after the transfer date established under section 311 of the Dodd-Frank Act (12 U.S.C. 5411)), or any subsidiary of the foregoing.

SEC: All entities other than those assigned to the FDIC, OCC, or Board.

Abstract: The notice sets forth permissible forms of risk retention for securitizations that involve issuance of asset-backed securities. The information requirements in joint regulations proposed by the three Federal banking agencies and the Commission are found in §§__.4, __.5, __.6, __.7, __.8, __.9, __.10, __.12, __.13, __.15, __.18, __.19, and __.20. The Agencies believe that the disclosure and recordkeeping requirements associated with the various forms of risk retention will enhance market discipline, help ensure the quality of the assets underlying a securitization transaction, and assist investors in evaluating transactions. Compliance with the information

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[220] The affected public of the FDIC, OCC, and Board is assigned generally in accordance with the entities covered by the scope and authority section of their respective proposed rule. The affected public of the Commission is based on those entities not already accounted for by the FDIC, OCC, and Board.

collections would be mandatory. Responses to the information collections would not be kept confidential and, except as provided below, there would be no mandatory retention period for proposed collections of information.

Section-by-Section Analysis

Section __.4 sets forth the conditions that must be met by sponsors electing to use the vertical risk retention option. Section __.4(b)(1) requires disclosure of the amount of each class of ABS interests retained and required to be retained by the sponsor and § __.4(b)(2) requires disclosure of material assumptions used to determine the aggregate dollar amount of ABS interests issued in the transaction.

Section __.5 specifies the conditions that must be met by sponsors using the horizontal risk retention option, including disclosure of the amount of the eligible horizontal residual interest retained by the sponsor and the amount required to be retained (§__.5(c)(1)(i)); disclosure of the material terms of the eligible horizontal residual interest (§__.5(c)(1)(ii)); disclosure of the dollar amount to be placed in a cash reserve account and the amount required to be placed in the account (§__.5(c)(2)(i)), if applicable; disclosure of the material terms governing the cash reserve account (§__.5(c)(2)(ii)), if applicable; and disclosure of material assumptions and methodology used in determining the aggregate dollar amount of ABS interests issued in the transaction (§__.5(c)(3)).

Section __.6 identifies the requirements for sponsors opting to use the hybrid L-shaped risk retention method, including disclosures in compliance with those set forth for the vertical and horizontal risk retention methods (§__.6(b)).

Section __.7 requires sponsors using a revolving master trust structure for securitizations to disclose the amount of seller's interest retained by the sponsor and the amount the sponsor is required to retain (§__.7(b)(1)); the material terms of the seller's interest retained by the sponsor (§__.7(b)(2)); and the material assumptions and methodology used in determining the aggregate dollar amount of ABS issued in the transaction (§__.7(b)(3)).

Section __.8 discusses the representative sample method of risk retention and requires that the sponsor adopt and adhere to policies and procedures to, among other things, document the material characteristics used to identify the designated pool and randomly select assets using a process that does not take account of any asset characteristic other than the unpaid balance (§__.8(c)); maintaining, until all ABS interests are paid in full, documentation that clearly identifies the assets included in the representative sample (§__.8(c)); obtaining an agreed upon procedures report from an independent public accounting firm (§__.8(d)(1)); disclose the amount of assets included in the representative sample and retained by the sponsor and the amount of assets required to be retained by the sponsor (§__.8(g)(1)(i)); disclose prior to sale a description of the material characteristics of the designated pool (§__.8(g)(1)(ii)); disclose prior to sale a description of the policies and procedures used by the sponsor to ensure compliance with random selection and equivalent risk determination requirements (§__.8(g)(1)(iii)); confirm prior to sale that the required agreed upon procedures report was obtained (§__.8(g)(1)(iv)); disclose the material assumptions and methodology used in determining the aggregate dollar amount of ABS interests issued in the transaction (§__.8(g)(1)(v)); and disclose after sale the performance of the pool of assets in the securitization transaction as compared to performance of assets in the representative sample (§__.8(g)(2)); and disclose to holders of the asset-backed securities information concerning the assets in the representative sample (§__.8(g)(3)).

Section __.9 addresses the requirements for sponsors utilizing the ABCP conduit risk retention approach. The requirements for the ABCP conduit risk retention approach include disclosure of each originator-seller with a retained eligible horizontal residual interest and the form, amount, and nature of the interest (§__.9(b)(1)); disclosure of each regulated liquidity provider providing liquidity support to the ABCP conduit and the form, amount, and nature of the support (§__.9(b)(2)); maintenance of policies and procedures that are reasonably designed to monitor regulatory compliance by each originator-seller of the eligible ABCP conduit (§__.9(c)(2)(i)); and notice to holders of the ABS interests issued in the transaction in the event of originator-seller regulatory non-compliance (§__.9(c)(2)(ii)).

Section __.10 sets forth the requirements for sponsors utilizing the commercial mortgage-backed securities risk retention option, and includes disclosures of the name and form of organization of the third-party purchaser (§__.10(a)(5)(i)), the third-party purchaser's experience (§__.10(a)(5)(ii)), other material information (§__.10(a)(5)(iii)), the amount and purchase price of eligible horizontal residual interest retained by the third-party purchaser and the amount that the sponsor would have been required to retain (§__.10(a)(5)(iv) and (v)), a description of the material terms of the eligible residual horizontal interest retained by the third-party purchaser (§__.10(a)(5)(vi)), the material assumptions and methodology used to determine the aggregate amount of ABS interests issued by the issuing entity (§__.10(a)(5)(vii)), representations and warranties concerning the securitized assets and factors used to determine the assets should be included in the pool (§__.10(a)(5)(viii)); sponsor maintenance of policies and procedures to monitor third-party compliance with regulatory requirements (§__.10(b)(2)(A)); and sponsor notice to holders of ABS interests in the event of third-party non-compliance with regulatory requirements (§__.10(b)(2)(B)).

Section __.12 requires the establishment of a premium cash reserve account, in addition to the sponsor's base risk retention requirement, in instances where the sponsor structures a securitization to monetize excess spread on the underlying assets. The premium cash reserve account would be used to "capture" the premium received on sale of such tranches for purposes of covering losses on the underlying assets and would require the sponsor to make disclosures regarding the dollar amount required by regulation to be placed in the account and any other amounts placed in the account by the sponsor (§__.12(d)(1)) and the material assumptions and methodology used in determining fair value of any ABS interest that does not have a par value and that was used in calculating the amount required for the premium capture cash reserve account (§__.12(d)(2)).

Section __.13 sets forth the conditions that apply when the sponsor of a securitization allocates to originators of securitized assets a portion of the credit risk it is required to retain, including disclosure of the name and form of organization of any originator with an acquired and retained interest (§__.13(a)(2)); maintenance of policies and procedures that are reasonably designed to monitor originator compliance with retention amount and hedging, transferring and pledging requirements (§__.13(b)(2)(A)); and notice to holders of ABS interests in the transaction in the event of originator non-compliance with regulatory requirements (§__.13(b)(2)(B)).

Section __.15 provides an exemption from the risk retention requirements for qualified residential mortgages that meet certain specified criteria including certification by the depositor of the asset-backed security that it has evaluated the effectiveness of its internal supervisory controls and concluded that the controls are effective (§__.15(b)(4)(i)), and sponsor disclosure prior to sale of asset-backed securities in the issuing entity of a copy of the certification to potential investors (§__.15(b)(4)(iii)). In addition §__.15(e)(3) provides that a sponsor that has relied upon the exemption shall not lose the exemption if it complies with certain specified requirements, including prompt notice to the holders of the asset-backed securities of any loan repurchased by the sponsor. Section _.15 also contains additional information collection requirements on the mortgage originator to include terms in the mortgage transaction documents under which the creditor commits to having servicing policies and procedures (§__.15(d)(13)(i)) and to provide disclosure of the foregoing default mitigation commitments to the borrower at or prior to the closing of the mortgage transaction (§__.15(d)(13)(ii)).

Sections __.18, __.19, and ___.20 provide exemptions from the risk retention requirements for qualifying commercial real estate loans, commercial mortgages, and auto loans that meet specified criteria. Each section requires that the depositor of the asset-backed security certify that it has evaluated the effectiveness of its internal supervisory controls and concluded that its controls are effective (§§__.18(b)(7)(i), __.19(b)(10)(i), and __.20(b)(9)(i)); that the sponsor provide a copy of the certification to potential investors prior to the sale of asset-backed securities (§§__.18(b)(7)(iii), __.19(b)(10)(iii), and __.20(b)(9)(iii)); and that the sponsor promptly notify the holders of the securities of any loan included in the transaction that is required to be repurchased by the sponsor (§§__.18(c)(3), __.19(c)(3), and __.20(c)(3)).

Estimated Paperwork Burden

Estimated Burden Per Response:

§__.4 - Vertical risk retention: disclosures – 2 hours.

§__.5 - Horizontal risk retention: disclosures – 2.5 hours.

§__.6 – L-Shaped risk retention: disclosures – 3 hours.

§__.7 – Revolving master trusts: disclosures 2.5 hours.

§__.8 – Representative sample: recordkeeping – 120 hours; disclosures – 23.25 hours.

§__.9 – Eligible ABCP conduits: recordkeeping – 20 hours; disclosures – 3 hours.

§__.10 – Commercial mortgage-backed securities: recordkeeping – 20 hours; disclosures – 19.75 hours.

§__.12 – Premium capture cash reserve account: disclosures – 1.75 hours.

§__.13 – Allocation of risk retention: recordkeeping 20 hours; disclosures 2.5 hours.

§__.15 – Exemption for qualified residential mortgages: recordkeeping – 40 hours; disclosures 9.25 hours.

§__.18 – Exemption for qualifying CRE loans: recordkeeping – 40 hours; disclosures – 1.25 hours.

§__.19 – Exemption for qualifying commercial mortgages: recordkeeping – 40 hours; disclosures – 1.25 hours.

§__.20 – Exemption for qualifying auto loans: recordkeeping – 40 hours; disclosures – 1.25 hours.

FDIC

Number of Respondents: 90 sponsors and 4,715 creditors.

Total Estimated Annual Burden: 59,463 hours.

OCC

Number of Respondents: 30 sponsors and 1,650 creditors.

Total Estimated Annual Burden: 20,483 hours.

Board

Number of Respondents: 20 sponsors and 7,636 creditors.

Total Estimated Annual Burden: 70,430 hours.

Commission

Number of Respondents: 104 sponsors and 1,500 creditors.

Total Estimated Annual Burden: 37,166 hours.

Commission's explanation of the calculation:

To determine the total paperwork burden for the requirements contained in this proposed rule the Agencies first estimated the universe of sponsors that would be required to comply with the proposed disclosure and recordkeeping requirements. The Agencies estimate that approximately 243 unique sponsors conduct ABS offerings per year. This estimate was based on 2010 data reported on the commercial bank Call Report (FFIEC 031 and 041) and from the ABS database AB Alert. Of the 243 sponsors, the Agencies have assigned 8 percent of these sponsors to the Board, 12 percent to the OCC, 37 percent to the FDIC, and 43 percent to the Commission.

Next, the Agencies estimated the burden per response that would be associated with each disclosure and recordkeeping requirement. In some cases, the proposed rule is estimated to incur only an incremental burden on respondents. For example, in the representative sample option, the proposed rule requires that the sponsor cause to be disclosed information regarding the securitized assets, but the Agencies believe similar information regarding the securitized assets are already being made to investors, and therefore the proposed rule would only incur an incremental burden on sponsors.

Next, the Agencies estimated how frequent the entities would make the required disclosure by estimating the proportionate amount of offerings per year for each agency. In making this determination, the estimate was based on the average number of ABS offerings from 2004 through 2009, and therefore, we estimate the total number of annual offerings per year to be 1,700.[221] We also made the following additional estimates:

- 12 offerings per year will be subject to disclosure and recordkeeping requirements under sections §__.12 and §__.13, which are divided equally among the four agencies (i.e., 3 offering per year per agency);
- 100 offerings per year will be subject to disclosure and recordkeeping requirements under section §__.15, which are divided proportionately among the agencies based on the entity percentages described above (i.e., 8 offerings per year subject to §__.15 for the Board; 12 offerings per year subject to §__.15 for the OCC; 37 offerings per year subject to §__.15 for the FDIC; and 43 offerings per year subject to §__.15 for the Commission); and

[221] We use the ABS issuance data from Asset-Backed Alert on the initial terms of offerings, and we supplement that data with information from Securities Data Corporation (SDC). This estimate includes registered offerings and offerings made under Securities Act Rule 144A. We also note that this estimate is for offerings that are not exempted under §§ _.21 and _.22 of the proposed rule.

- 40 offerings per year will be subject to disclosure and recordkeeping requirements under §__.18, §__.19, and §__.20, respectively, which are divided proportionately among the agencies based on the entity percentages described above (i.e., 3 offerings per year subject to each section for the Board, 5 offerings per year subject to each section for the OCC; 15 offerings per year subject to each section for the FDIC, and 17 offerings per year subject to each section for the Commission).

To obtain the estimated number of responses (equal to the number of offerings) for each option in Part B of the proposed rule, the Agencies multiplied the number of offerings estimated to be subject to the base risk retention requirements (i.e., 1,480)[222] by the sponsor percentages described above. The result was the number of base risk retention offerings per year per agency. For the Commission, this was calculated by multiplying 1,480 offerings per year by 43 percent, which equals 636 offerings per year. This number was then divided by the number of base risk retention options (7) to arrive at the estimate of the number of offerings per year per agency per base risk retention option. For the Commission, this was calculated by dividing 636 offerings per year by 7 options, resulting in 91 offerings per year per base risk retention option.

The total estimated annual burden for each Agency was then calculated by multiplying the number of offerings per year per section for such Agency (except with respect to the recordkeeping burden hours under §__.8 and §_.15(d)(13) as described below) by the number of burden hours estimated for the respective section, then adding

[222] Estimate of 1,700 offerings per year minus the estimate of the number of offerings qualifying for an exemption under §__.15, §__.18, §__.19, and §__.20 (220 total).

these subtotals together. For example, under §__.4, the Commission multiplied the estimated number of offerings per year per §__.4 (i.e., 91 offerings per year) by the disclosure burden hour estimate for §__.4 of 2.0 hours. Thus, the estimated annual burden hours for respondents to which the Commission accounts for the burden hours under §__.4 is 182 hours (91 * 2.0 hours = 182 hours). For the recordkeeping burden estimate under §§__.8(c) and__.8(d)(2), instead of using the number of offerings per year per base risk retention option, the Agencies multiplied the number of recordkeeping burden hours by the number of unique sponsors assigned to such Agency per year (i.e., 104 in the case of the Commission).[223] The reason for this is that the Agencies considered it possible that sponsors may establish these policies and procedures during the year independent on whether an offering was conducted, with a corresponding agreed upon procedures report obtained from a public accounting firm each time such policies and procedures are established.

To obtain an estimate for the number of burden hours required by § _.15(d)(13), the Agencies multiplied the estimate of the number of creditors assigned to such Agency for purposes of this risk retention rule by an estimate of the number of hours that it will take creditors to perform a one-time update to their systems to account for the requirements of this section, which we estimate to be 8 hours.[224] This estimate was added to the other disclosure and recordkeeping burden estimates as described above to achieve a total estimated annual burden for respondents assigned to the Commission.

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[223] 243 * 43% = 104.

[224] 1,500 creditors * 8 hours = 12,000 hours

For disclosures made at the time of the securitization transaction,[225] the Commission allocates 25 percent of these hours (1,009 hours) to internal burden for all sponsors. For the remaining 75 percent of these hours, (3,028 hours), the Commission uses an estimate of $400 per hour for external costs for retaining outside professionals totaling $1,211,200. For disclosures made after the time of sale in a securitization transaction,[226] the Commission allocated 75 percent of the total estimated burden hours (892 hours) to internal burden for all sponsors. For the remaining 25 percent of these hours (297 hours), the Commission uses an estimate of $400 per hour for external costs for retaining outside professionals totaling $118,800. With respect to the agreed upon procedures report by an independent public accounting firm under the representative sample option, the Commission allocated 100 percent of the total estimated burden hours (4,160 hours[227]) to retaining outside professionals at an estimate of $400 per hour, for a total cost of $1,664,000.

FHFA: The proposed regulation does not contain any FHFA information collection requirement that requires the approval of OMB under the Paperwork Reduction Act.

HUD: The proposed regulation does not contain any HUD information collection requirement that requires the approval of OMB under the Paperwork Reduction Act

C. Commission Economic Analysis

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[225] These are the disclosures required by §§_.4(b)(1)-(2); _.5(c)(1)(i)-(ii), (2)(i)-(ii), and (3); _.6(b); _.7(b)(1)-(3); _.8(g)(1)(i)-(iv) and (g)(3); _.9(b)(1)-(2); _.10(a)(5)(i)-(viii); _.12(d)(1)-(3); _.13(a)(2); _.15(b)(4)(iii); _.18(b)(7)(iii); _.19(b)(10)(iii); and _.20(b)(9)(iii).

[226] These are the disclosures required by §§_.8(g)(2); _.9(c)(2)(ii); _.10(b)(2)(B); _.13(b)(2)(B); _15(e)(3); _.18(c)(3); _19(c)(3); and _.20(c)(3).

[227] 40 * 104 = 4,160 hours.

1. Introduction

As discussed above, Section 15G of the Exchange Act, as added by section 941(b) of the Dodd-Frank Act, generally requires the Agencies to jointly prescribe regulations, that (i) require a sponsor to retain not less than five percent of the credit risk of any asset that the sponsor, through the issuance of an ABS, transfers, sells, or conveys to a third party, and (ii) prohibit a sponsor from directly or indirectly hedging or otherwise transferring the credit risk that the sponsor is required to retain under section 15G and the Agencies' implementing rules.[228]

Section 15G of the Exchange Act exempts certain types of securitization transactions from these risk retention requirements and authorizes the Agencies to exempt or establish a lower risk retention requirement for other types of securitization transactions. For example, section 15G specifically provides that a sponsor shall not be required to retain any part of the credit risk for an asset that is transferred, sold, or conveyed through the issuance of ABS by the sponsor, if all of the assets that collateralize the ABS are qualified residential mortgages (QRMs), as that term is jointly defined by the Agencies.[229] In addition, section 15G states that the Agencies must permit a sponsor to retain less than five percent of the credit risk of commercial mortgages, commercial loans, and automobile loans that are transferred, sold, or conveyed through the issuance of ABS by the sponsor if the loans meet underwriting standards established by the Federal banking agencies.[230]

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[228] See 15 U.S.C. §78o-11(b), (c)(1)(A) and (c)(1)(B)(ii).

[229] See 15 U.S.C. § 78o-11(c)(1)(C)(iii), (4)(A) and (B).

[230] See id. at § 78o-11(c)(1)(B)(ii) and (2).

Section 15G requires the Agencies to prescribe risk retention requirements for "securitizers," which the Agencies interpret are depositors or sponsors of ABS. The proposal would require that a "sponsor" of a securitization transaction to retain the credit risk of the securitized assets in the form and amount required by the proposed rule. The Agencies believe that imposing the risk retention requirement on the sponsor of the ABS is appropriate in light of the active and direct role that a sponsor typically has in arranging a securitization transaction and selecting the assets to be securitized.

In developing the proposed rules, the Agencies have taken into account the diversity of assets that are securitized, the structures historically used in securitizations, and the manner in which sponsors may have retained exposure to the credit risk of the assets they securitize. The proposed rules provide several options sponsors may choose from in meeting the risk retention requirements of section 15G, including, but not limited to, retention of a five percent "vertical" slice of each class of interests issued in the securitization or retention of a five percent "horizontal" first-loss interest in the securitization, as well as other risk retention options that take into account the manners in which risk retention often has occurred in credit card receivable and automobile loan and lease securitizations and in connection with the issuance of asset-backed commercial paper. The proposed rules also include a special "premium capture" mechanism designed to prevent a sponsor from structuring an ABS transaction in a manner that would allow the sponsor to effectively negate or reduce its retained economic exposure to the securitized assets by immediately monetizing the excess spread created by the securitization transaction. In designing these options and the proposed rules in general, the Agencies have sought to ensure that the amount of credit risk retained is meaningful—consistent with the purposes of section 15G—while reducing the potential for the proposed rules to negatively affect the availability and costs of credit to consumers and businesses.

As required by section 15G, the proposed rules provide a complete exemption from the risk retention requirements for ABS that is collateralized solely by QRMs and establish the terms and conditions under which a residential mortgage would qualify as a QRM. In developing the proposed definition of a QRM, the Agencies carefully considered the terms and purposes of section 15G, public input, and the potential impact of a broad or narrow definition of QRMs on the housing and housing finance markets.

As discussed in greater detail in Part IV of this Supplementary Information, the proposed rule would generally prohibit QRMs from having product features that contributed significantly to the high levels of delinquencies and foreclosures since 2007—such as terms permitting negative amortization, interest-only payments, or significant interest rate increases—and also would establish underwriting standards designed to ensure that QRMs are of very high credit quality consistent with their exemption from risk retention requirements. These underwriting standards include, among other things, maximum front-end and back-end debt-to-income ratios of 28 percent and 36 percent, respectively; a maximum loan-to-value ratio of 80 percent in the case of a purchase transaction (with a lesser combined LTV permitted for refinance transactions); a 20 percent down payment requirement in the case of a purchase transaction; and credit history restrictions.

The proposed rules also would not require a sponsor to retain any portion of the credit risk associated with a securitization transaction if the ABS issued are exclusively collateralized by qualified assets (QAs) -- commercial loans, commercial mortgages, or automobile loans that meet underwriting standards included in the proposed rule for the individual asset class.

The Commission is sensitive to the costs and benefits imposed by its rules. The discussion below focuses on the costs and benefits of the decisions made by the Commission, together with the other Agencies, to fulfill the mandates of the Dodd-Frank Act within its permitted discretion, rather than the costs and benefits of the mandates of the Dodd-Frank Act itself. For instance, the analysis below assumes as a baseline that a standard for QRM is in place, since such a standard is mandated by statute. Rather than assessing the economic costs and benefits of implementing such a standard, the analysis below focuses on the relative costs and benefits of alternative QRM standards. Similarly, the analysis assumes the following: a risk retention requirement of at least 5 percent for non-qualified mortgages and non-qualified assets, 0% for QRMs and less than 5 percent for qualified assets. Thus, our analysis below examines the costs and benefits of alternative implementations of a risk retention requirement meeting the mandates of the Dodd-Frank Act, rather than the existence of a risk retention requirement. Although our intent is to limit the economic analysis of this rule to decisions made by the Commission, to the extent that the Commission's discretion is exercised to further the benefits intended by the Dodd-Frank Act, the two types of benefits might not be entirely separable.

Section 23(a)(2) of the Exchange Act requires the Commission, when making rules under the Exchange Act, to consider the impact on competition that the rules would have, and prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the Exchange Act.[231] Further, Section 2(b) of the Securities Act of 1933[81] and Section 3(f) of the Exchange Act requires the Commission,[232] when engaging in rulemaking where we are required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation. The Commission has considered and discussed below the effects of the proposed rules on efficiency, competition, and capital formation, as well as the benefits and costs associated with the Commission's decisions in the proposed rulemaking.

2. Risk Retention Methods for non-QRMs and non-qualifying assets ("QAs")

The proposed rules require not less than 5 percent risk retention for all non-QRMs and non-QAs. The form of the retention is to be chosen from a menu of options, which should provide flexibility to sponsors in meeting the risk retention requirement mandated by Section 15G, as added by the Dodd-Frank Act. Section 15G directs the Agencies to set appropriate risk retention rules, which will require the retention of no less than 5 percent of the credit risk in the securitized assets for all ABS classes not exempt from the requirement. Section 15G provides for a risk retention exemption for sponsors of ABS backed solely by QRMs and for certain other sponsors or ABS asset classes as discussed below and a less than five percent risk retention requirement for QAs.

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[231] 15 U.S.C. 78w(a)..

[232] 17 U.S.C. 78c(f).

Empirical evidence points to a significant heterogeneity of securitization structures, practices and risk characteristics across ABS asset classes.[233] Accordingly, allowing sponsors to choose a form of risk retention from a menu of options provides them with the flexibility of choosing the form that best suits their operational and financing preferences. By including most of the risk retention forms currently observed in the marketplace, the Agencies' proposal benefits sponsors, originators, and investors alike by limiting disruption to current securitization practices to the extent possible. Historically, most sponsors have been exposed to some level of credit risk by retaining an economic interest in the pools they securitize in the form of first-loss or pro-rata positions.[234] Thus, the proposed rule allows sponsors that have existing risk retention programs to minimize their compliance costs resultant from the statute's mandate. Without the flexibility allowed by a broad menu-of-options approach, there likely would be an increase in borrowing costs to sponsors and to the borrowers whose loans are in the securitized pools. In some cases, this increase could be large enough to make certain types of securitizations economically unfeasible.

It is possible that the flexibility allowed by the proposed approach to implementing the risk retention mandate of Section 15G might result in some sponsors choosing risk retention methods that do not align fully their incentives with those of

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[233] See Board of Governors of the Federal Reserve System, Report to the Congress on Risk Retention, October 2010 available at http://federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf.

[234] For example, Chen, Liu, and Ryan (2008) show that banks retain more risk when loans have higher or less externally verifiable credit risk. See *Characteristics of Securitizations that Determine Issuers' Retention of the Risks of the Securitized,* Weitzu Chen, Chi-Chun Liu, and Stephen Ryan (2008), The Accounting Review, 2008.83.5.1181.

investors. In such cases, underwriting standards and pool selection procedures may not improve. If investors are reluctant to invest in ABS where a sponsor has selected such a suboptimal risk retention method, risk retention might not have the effect of facilitating capital formation. To the extent that such reluctance on part of investors provides sponsors with the incentive to choose risk retention methods that investors demand, this effect on capital formation is mitigated.

An integral part of the proposed rules are new risk retention disclosure requirements specifically tailored to each of the permissible forms of risk retention. The required disclosure would provide investors with information on the sponsor's retained interest in an ABS transaction, such as the amount and form of the interest retained and the assumptions used in determining the aggregate value of ABS to be issued. This information would benefit investors by providing them with an efficient mechanism to monitor compliance with the proposed rules and make informed investment decisions. However, compliance costs to sponsors would increase, since sponsors would now have to prepare and provide these disclosures to investors.

Therefore, the Commission believes that the proposed menu-of-options approach and the accompanying disclosures will have no competitive effects, and will implement the mandates of Section 15G without causing economic inefficiencies or hindering capital formation.[235]

<u>Vertical Risk Retention Method</u>

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[235] As discussed in the introduction, this statement refers to the choice made by the Commission and other agencies by having proposed a menu of options rather than the statutory mandate to require risk retention.

By requiring the retention of five percent of each interest backed by the securitized asset pool, regardless of whether the interest is certificated or not, the vertical risk retention method is the most straightforward method to implement. The transparency and ease of verification of this method will likely benefit investors to the extent that they view their ability to discern a sponsor's risk retention important. This provides the sponsor an interest in the entire structure of the securitization transaction. However, the vertical risk retention method requires a sponsor to bear only a small fraction of the losses incurred by the pool, thus possibly failing to align sufficiently originators' and sponsors' interests with those of investors when it comes to the origination and underwriting of riskier asset classes. Since 5 percent is a lower bound on the risk required to be retained, it is possible some sponsors may hold more if it were economically optimal.

Horizontal Risk Retention Method

This method exposes a sponsor to the first 5 percent of all pool-asset losses and thus results in the sponsor retaining substantially more than five percent of the credit risk in a securitization. That is, a sponsor will be exposed to 100 percent of all losses as long as those losses are up to 5 percent. Therefore, this method imposes a significant disincentive on sponsors of poorly underwritten assets. As a result, the horizontal method of risk retention should benefit investors by aligning their incentives with those of originators and sponsors when originating and underwriting riskier asset classes.

Since the retention of a horizontal first-loss position in securitizations leaves the sponsor holding a significant amount of risk, it is possible that for less risky asset classes a 5 percent risk retention might be unnecessarily high. For such asset classes, a sponsor might be constrained to raising external financing for only 95 percent of the asset pool, while the market might have allowed for a smaller equity interest. As a result, the sponsor might have to incur additional financing costs which would have the effect of impeding capital formation.

The retention of a first-loss position has been a common market practice for many asset classes, so this method should not be unnecessarily disruptive and should therefore impose limited additional costs on sponsors. The effect would be that of no decrease in efficiency and no new impediment to capital formation.

Premium Capture Cash Reserve Account

Securitization transactions often contain pools of assets that are expected to earn substantially higher returns compared to the financing rates on the ABS issued in the securitization. This is generally referred to as excess spread. In situations where there is substantial excess spread, the sponsor can obtain significant economic income by selling an interest based on the excess spread. If the sponsor is able to recover more than 5 percent of the balance of the pool in a short period of time, then the sponsor would be left with limited economic interest in the securitization. This is particularly true if defaults occur later in the life of pool assets. For this reason, the proposed rules prohibit the cash flows from the excess spread (or cash proceeds from selling it) to be distributed to the sponsor. This benefits investors by helping to ensure that the incentive-alignment objectives of the proposed rules are achieved. However, this may reduce the flexibility of sponsors in structuring their deals, thus imposing a cost.

L-Shaped Method

Another risk retention option in the proposed rules would allow a sponsor, subject to certain conditions, to use an equal combination of a vertical risk retention and horizontal risk retention as a means of retaining the required five percent exposure to the credit risk of the securitized assets. This form of risk retention is referred to as an "L-Shaped" form of risk retention because it combines both vertical and horizontal forms. Overall, this has the benefits and costs associated with the two approaches as described above. Also, the proposed requirement that the sponsor retain 50 percent vertical and 50 percent horizontal facilitates the monitoring of the risk retention compliance by investors, Agencies and other market participants.

Representative Sample Method

The representative sample method requires risk retention of a randomly selected loan pool that is "similar" in risk attributes to the securitized loans *prior to* a securitization. Since it may be costly to ensure the true "randomness" of the selection or "representativeness" of the sample, and since sponsors' prior knowledge of the sample selection bias might alter their incentives to put well-underwritten assets into the pool, this method may not fulfill its incentive-alignment benefits without mechanisms in place to ensure there is no selection bias. Thus, the proposed rules require that sponsors have plans and procedures in place, maintain documentation, and have the sampling procedures agreed upon by an independent auditing firm. In addition, the proposed rules would require ongoing disclosures about the performance of the assets in the representative sample in the same form, level, and manner as is provided concerning the securitized assets. Although this will increase sponsors' compliance costs, the

Commission believes that it will also further the incentive-alignment benefits contemplated in Section 15G of the Exchange Act.

For some asset classes, such as automobile loans, retaining a portion of the loans that would ordinarily be securitized has been used as a method of risk retention. Therefore, permitting a representative sample risk retention option with the appropriate safeguards will likely benefit sponsors of such asset classes, whose compliance costs – other than reporting costs – will not increase as a result of the proposed rules. Furthermore, the borrowers whose loans back such securitizations will also likely experience no increase in their borrowing costs.

Seller's Interest Method

Securitizations of revolving lines of credit, such as credit card accounts or dealer floorplan loans, are typically structured using a revolving master trust, which issues more than one series of ABS backed by a single pool of revolving assets. The proposed rule would allow a sponsor of a revolving asset master trust that is collateralized by revolving loans or other extensions of revolving credit to meet its risk retention requirement by retaining a seller's interest in an amount not less than 5 percent of the unpaid principal balance of the pool assets held by the issuer. The definitions of a seller's interest and a revolving asset master trust are intended to be consistent with market practices and, with respect to seller's interest, designed to help ensure that any seller's interest retained by a sponsor under the proposal would expose the sponsor to the credit risk of the underlying assets. This should benefit all parties to the securitization by balancing implementation costs for sponsors utilizing the master trust structure with incentive-alignment benefits for investors.

3. Definition of Qualified Residential Mortgages

Section 15G requires the Commission, along with the other Agencies, to jointly specify underwriting standards for QRMs that take into consideration underwriting and product features that historical loan performance data indicate result in lower risk of default. Section 15G exempts ABS entirely backed by QRMs from the risk retention mandated by Section 15G. In defining QRMs, the Agencies examined data on mortgage performance supplied by Lender Processing Services' ("LPS") Applied Analytics division (formerly McDash Analytics). To minimize performance differences arising from unobservable changes across products, and to focus on loan performance through stressful environments, the analysis generally used prime fixed-rate loans originated from 2005 to 2008. Since the LPS data do not include detailed borrower information, the Agencies also analyzed data from the triennial Survey of Consumer Finances ("SCF") for the 1992-2007 period. To isolate the borrower characteristics closest in time to the mortgage origination, the analysis was limited to the approximately 1,500 families, who purchased their homes in the year prior to or of the survey. The Agencies also examined a combined data set of loans purchased or securitized by the Enterprises from 1997 to 2009. This data set consisted of more than 78 million mortgages, and included data on loan products and terms, borrower characteristics (e.g., income and credit score), and performance data through the third quarter of 2010.

The analysis of the data described above and the conclusions of numerous academic studies support a definition of QRM that takes into account the following underwriting and product features: the borrower's ability to repay the mortgage (as captured the borrower's debt-to-income ratio); the borrower's credit history; the borrower's down payment amount and sources; the loan-to-value ratio for the loan; the form of valuation used in underwriting the loan; the type of mortgage involved; and the owner-occupancy status of the property securing the mortgage.[236] The Commission believes that selecting this subset of features will be beneficial to loan originators, because these are the features typically considered in the mortgage underwriting process. Although there might be factors among those listed above that loan originators had not previously used in their lending decisions, the Commission believes that this is unlikely. Thus, the Commission expects that loan originators would not have to incur significant new or additional costs to collect information on these specific underwriting and product features, which should have the effect of not unnecessarily disrupting existing lending practices. As a result, the Commission expects that mortgage rates would not be adversely impacted by the Agencies' choice of the features used to define QRMs and therefore this choice would not have a negative effect on efficiency and capital formation.

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[236] See Demyanyk, Yuliya, and Otto Van Hemert, "Understanding the Subprime Crisis," Working paper. St. Louis, Missouri: Federal Reserve Bank of St. Louis (2008); Quercia, Roberto, Michael Stegman, and Walter R. Davis, "Residential Mortgage Default: A Review of the Literature," Journal of Housing Research 3(2): 341-379 (2005); Ambrose, Brent W., Michael LaCour-Little, and Zsuzsa Huszar, "A Note on Hybrid Mortgages," Real Estate Economics 33(4): 765-782 (2005); Anderson, Dennis Capozza and Robert Van Order, "Deconstructing the Mortgage Meltdown: A Methodology for Decomposing Underwriting Quality," Social Science Research Network. http://ssrn.com/abstract=1411782 (2009); Gerardi, Kristopher, Andreas Lehnert, Shane Sherlund, and Paul Willen "Making Sense of the Subprime Crisis," Brookings Papers on Economic Activity (Fall 2008), 59-145; Austin Kelly, "Skin in the Game: Zero Down Payment Mortgage Default," Federal Housing Finance Agency, Journal of Housing Research, Vol. 19, No. 2 (2008); Neil Bhutta, Jane Dokko and Hui Shan, "The Depth of Negative Equity and Mortgage Default Decisions," Finance and Economics Discussion Series, Federal Reserve Board, 2010-35 (2010); Deng, Yongheng, John M. Quigley and Robert van Order (2000), "Mortgage Terminations, Heterogeneity and the Exercise of Mortgage Options," Econometrica, Vol. 68, No. 2 (2000), pp. 275-307.

The Agencies also have sought to make the standards applicable to QRMs transparent to, and verifiable by, originators, securitizers, investors and supervisors. The Commission believes that investors will also benefit from the proposed approach to defining QRMs using the above subset of mortgage features, since these include the factors most commonly considered by the market as determinants of loan quality and expected mortgage default. Therefore, investors will likely be familiar with them, which will have the effect of facilitating investors' interpretation and understanding of the QRM standard as proposed.

When considering the underwriting and product features to be used in the QRM definition, the Agencies selected features that are transparent or verifiable. The Commission believes that this will benefit all entities involved in the securitization process. Loan originators will be able to easily discern whether a mortgage is a QRM during the underwriting process. Sponsors will be able to unambiguously determine whether an ABS is backed by QRMs alone and therefore qualifies for the risk retention exemption. And finally, investors will be able to assess without difficulty whether they are investing in a QRM ABS or not. Thus, the Commission expects that as a result of the transparency and verifiability of the mortgage features used to define QRMs, there will be no reduction in efficiency or impediment to capital formation.

Some of the QRM standards proposed by the Agencies rely on definitions and calculations which may be defined in multiple ways. To provide clarity, the Agencies are proposing the use of definitions of key terms as established in the U.S. Department of Housing and Urban Development (HUD) Handbook 4155.1 (New Version), Mortgage Credit Analysis for Mortgage Insurance, as in effect on December 31, 2010. Since the

HUD definitions have been time-tested and are well understood by the market, the Commission believes this approach will be efficient and beneficial to both investors and sponsors. On the other hand, loan originators and sponsors who have been using alternative definitions might incur adjustment costs, if they have to modify their loan origination systems and processes. These new lending costs might be passed onto borrowers in the form of higher mortgage rates or fees, thus impeding capital formation.

The QRM standards that the Agencies are proposing prescribe fixed thresholds for several borrower and loan features. For instance, a QRM cannot have a front-end debt-to-income ratio higher than 28 percent or a loan-to-value ratio higher than 80 percent. The thresholds chosen in the proposed rule reflect a balance between setting standards that are over- or under-conservative with regard to mortgage default risk. If the Agencies had been more conservative in their choices of thresholds such that fewer mortgages were QRMs, more sponsors would have incurred compliance costs for risk retention for non-QRMs. These additional costs would likely be passed on to borrowers whose loans comprise the securitized pool, which would have the effect of increasing mortgage rates for a larger proportion of home buyers. On the other hand, QRM standards that are more restrictive and that result in more non-QRMs would likely create a larger and therefore more liquid secondary market for non-QRMs, and thus reduce the liquidity premium for non-QRM ABS. The reduced liquidity premium, which would decrease non-QRM rates, might counteract the possible increase in non-QRM rates resulting from risk retention compliance costs.

The opposite would also have been true. If the Agencies had been less conservative in their choices of thresholds such that a larger fraction of mortgages would have qualified as QRMs, then non-QRMs might face illiquidity in the secondary market. However, fewer borrowers would have had to face increased mortgage rates resulting from compliance costs for risk retention.

4. Risk Retention Allocation for Non-QRMs and Non-QAs

Many securitization transactions are brought to the market by aggregators who purchase assets from one or many originators, combine these assets in a pool, and then issue securities backed by the assets to investors. This securitization chain allows for the possibility of implementing risk retention at either the originator or the sponsor level. Risk retention imposed directly on originators may be more effective in improving underwriting standards than if imposed on sponsors. On the other hand, many of the risk retention forms discussed earlier would be unfeasible to implement due to the complexity introduced by the two-stage nature of a securitization by an aggregator. Nonetheless, the Agencies believe that the imposition of risk retention on sponsors should still have the effect of improving underwriting standards. Sponsors would have strong incentives to monitor the lending practices of originators and consider these practices when acquiring pool assets. This likely will align originators' interests with those of sponsors, whose interests would now be aligned with those of investors through risk retention.

The proposed rules allow sponsors to allocate some of their risk retention responsibilities to originators, which would provide additional flexibility in complying with the requirements. However, the proposed rules do not allow the allocation of risk to an originator contributing a small share of assets to the securitized pool. Thus, the proposed allocation of risk retention is likely to benefit small loan originators by not allowing sponsors to pass onto them their own risk retention costs.

The Agencies are also proposing to allow risk retention allocation to a third-party purchaser in the securitization of commercial real estate loans. It has been a common market practice for a third-party purchaser to retain the first-loss position in commercial mortgage-backed transactions. This third-party buyer, also known as "B-piece buyer," is typically involved in the securitization early on and thus can significantly affect pool asset selection. The B-piece buyer reviews the loans and corresponding mortgage properties, and may ask for loans to be removed from the pool if underwriting issues are uncovered. Thus, the Agencies' decision to allow a B-piece buyer to meet a sponsor's risk retention obligations under Section 15G of the Exchange Act, will likely benefit both sponsors and investors. It accommodates existing market practices, thus minimizing sponsors' compliance costs while aligning the interests of investors with those of parties performing due diligence on the pool assets. In this way, the proposal should provide incentives for good underwriting and origination practices. Since a sponsor's risk retention obligation can be met by a B-piece buyer only under certain conditions described earlier, these conditions may increase B-piece buyers' cost of participating in CMBS transactions. B-piece buyers may be able to pass these costs to borrowers with an adverse effect on capital formation. However, the Commission preliminary believes that the conditions help ensure that the B-piece buyer's risk retention is consistent with the intent of Section 15G and would benefit investors, and ultimately facilitating capital formation.

As noted earlier, the B-piece buyer in CMBS transactions often acts in the capacity of a special servicer, which can create conflicts of interest between the B-piece buyer and senior tranche holders. To mitigate these conflicts of interest, the Agencies are proposing to have an operating adviser oversee the servicing activities of the B-piece buyer when the B-piece buyer acts in a capacity of a special servicer. While such a requirement would increase compliance costs, it should have the benefit of minimizing B-piece buyers' ability to manipulate cash flows through special servicing and by limiting B-piece buyers' ability to offset the consequences of poor underwriting through special servicing. In addition, it should incentivize B-piece buyers to avoid adding into the pool poorly underwritten or originated assets. This would be consistent with the purpose of Section 15G and would benefit investors, thus facilitating capital formation.

The Agencies are proposing yet another option for risk retention allocation, which is specifically designed for asset-backed commercial paper ("ABCP") conduits. This option takes into account the special structures through which this type of ABS is typically issued, as well as the manner in which exposure to the credit risk of the underlying assets is typically retained.

Although the proposal would allow the originator-sellers (rather than the sponsor) to retain the required eligible horizontal residual interest, the proposal also imposes certain obligations directly on the sponsor in recognition of the key role the sponsor plays in organizing and operating an eligible ABCP conduit. Most importantly, the proposal provides that the sponsor of an eligible ABCP conduit that issues ABCP in reliance on this option would be the securitization party ultimately responsible for compliance with the risk retention requirements of Section 15G of the Exchange Act. The proposal allows for an ABCP sponsor to be in compliance if each originator-seller retains a five-percent horizontal residual interest in each intermediate SPV established by or on behalf of that originator-seller for purposes of issuing interests to an eligible ABCP conduit. Since eligible ABCP conduits also provide full liquidity guarantees to commercial-paper investors by regulated liquidity providers, the flexibility allowed by the proposed rule benefits ABCP sponsors by allowing them to avoid costly duplicative risk retention and should have the effect of promoting capital formation in this important segment of the securitization market.

Further, the proposed rule avoids an outcome in which one originator-seller would have to be exposed to risks underwritten by other originator-sellers. Each originator-seller would be required to retain credit exposure only to its own receivables, thus properly aligning its incentives with those of ABCP investors.

5. Hedging Prohibitions

Hedging helps sponsors manage and mitigate their exposure to unwanted risks. For example, a securitizer may want to mitigate the interest rate risk of its ABS portfolio. Hedging is also a beneficial activity from a systemic risk perspective because it helps market participants redistribute risk. Given the benefits from hedging, the proposed rule aims to implement the risk retention mandate of Section 15G without unduly limiting a sponsor's risk management activities. This is accomplished by prohibiting hedging only to the extent that hedging would result in a sponsor no longer being exposed to the risk required to be retained by Section 15G of the Exchange Act.

The ability to hedge interest rate risk and similar risks increases economic efficiency and facilitates capital formation, because it allows securitizers to direct their capital and efforts towards activities of comparative advantage. For instance, a securitizer might have a superior ability of assessing the credit risk of residential mortgages, but be less skilled in forecasting interest-rate changes. Such a securitizer might find it more efficient to hedge the interest-rate risk of the residential mortgages collateralizing an RMBS rather than invest resources in improving its ability to understand and price this interest-rate risk. Furthermore, since interest-rate fluctuations are unrelated to underwriting deficiencies in the loan origination process, allowing a securitizer to hedge interest-rate risk will not compromise the incentive alignment contemplated by the Act. The ability to hedge also may help competition, because by hedging less diversified companies may be able to compete with more diversified companies that have weaker hedging incentives. Therefore, the proposed rules are designed to promote efficiency, competition and capital formation.

6. Treatment of Government-Sponsored Enterprises

The proposed rules, which allows the guarantees of Fannie Mae and Freddie Mac to satisfy the risk retention requirements while they are operating under the conservatorship or receivership of FHFA with capital support from the United States, as well as for any limited-life regulated entity succeeding to the charter and also operating with such capital support, avoid unnecessary costs to be incurred by sponsors until the statutory and regulatory framework for the Enterprises becomes clearer. The Commission believes that the capital support provided by the United States government makes additional risk retention unnecessary because as a result of the support investors in GSE ABS are not exposed to any credit losses. Thus, there would be no incremental benefit to be gained by requiring GSEs to retain risk.

7. Resecuritization Transactions

The Agencies have identified certain resecuritizations where duplicative risk retention requirements would provide no added benefit. Resecuritizations collateralized only by existing 15G-compliant ABS and financed through the issuance of a single class of securities so that all principal and interest payments received are evenly distributed to all security holders, are a unique category of resecuritizations. For them, the resecuritization process would neither increase nor reallocate the credit risk of the underlying ABS. Therefore, there would be no cost to investors from incentive misalignment with the securitizing sponsor. Furthermore, because this type of resecuritization may be used to aggregate 15G-compliant ABS backed by small asset pools, the exemption for this type of resecuritization could improve access to credit at reasonable terms to consumers and businesses by allowing for the creation of an additional investment vehicle for these smaller asset pools. The exemption would allow the creation of ABS that may be backed by more geographically diverse pools than those that can be achieved by the pooling of individual assets as part of the issuance of the underlying 15G-compliant ABS. Again, this will likely improve access to credit on reasonable terms.

Under the proposed rule, sponsors of resecuritizations that do not have the structure described above would not be exempted from risk retention. Resecuritization transactions, which re-tranche the credit risk of the underlying ABS, would be subject to risk retention requirements in addition to the risk retention requirement imposed on the underlying ABS. In such transactions, there is the possibility of incentive misalignment between investors and sponsors just as when structuring the underlying ABS. For such resecuritizations, the proposed rule seeks to ensure that this misalignment is addressed by not granting these resecuritizations with an exemption from risk retention. However, the proposed rules may have an adverse impact on capital formation and efficiency if they make some types of resecuritization transactions costlier or infeasible to conduct as a result of risk retention costs.

D. Executive Order 12866 Determination

The Office of Management and Budget (OMB) reviewed this proposed rule as it relates to programs and activities of the Department of Housing and Urban Development (HUD) under Executive Order 12866 (entitled "Regulatory Planning and Review"), and determined the rule as it relates to HUD to be an economically significant regulatory action, as provided in section 3(f)(1) of the Order. The docket file is available for public inspection in the Regulations Division, Office of General Counsel, Department of Housing and Urban Development, 451 7th Street, SW, Room 10276 Washington, DC 20410-0500. Due to security measures at the HUD Headquarters building, please schedule an appointment to review the docket file by calling the Regulations Division at 202-402-3055 (this is not a toll-free number). Individuals with speech or hearing impairments may access this number via TTY by calling the Federal Information Relay Service at 800-877-8339.

E. OCC Unfunded Mandates Reform Act of 1995 Determination

Section 202 of the Unfunded Mandates Reform Act of 1995, Public Law 104-4 (Unfunded Mandates Act) requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in expenditure by State, local, and tribal governments, in the aggregate, or by the private sector, of $100 million (adjusted for inflation) or more in any one year. The current inflation-adjusted expenditure threshold is $126.4 million. If a budgetary impact statement is required, section 205 of the UMRA also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule.

Based on current and historical supervisory data on national bank securitization activity, the OCC estimates that, pursuant to the proposed rule, national banks would be required to retain approximately $2.8 billion of credit risk, after taking into consideration the proposed exemptions for qualified residential mortgages and other qualified assets. The cost of retaining this risk amount has two components. The first is the loss of origination and servicing fees on the reduced amount of origination activity necessitated by the need to hold the $2.8 billion retention amount on the bank's balance sheet. Typical origination fees are 1 percent and typical servicing fees are another half of a percentage point. To capture any additional lost fees, the OCC conservatively estimated that the total cost of lost fees to be two percent of the retained amount, or approximately $56 million. The second component of the retention cost is the opportunity cost of earning the return on these retained assets versus the return that the bank would earn if these funds were put to other use. Because of the variety of assets and returns on the securitized assets, the OCC assumes that this interest opportunity cost nets to zero. In addition to the cost of retaining the assets under the proposed rule, the overall cost of the proposed rule includes the administrative costs associated with implementing the rule and providing required disclosures. The OCC estimates that implementation and disclosure will require approximately 480 hours per institution, or at $100 per hour, approximately $48,000 per institution. The OCC estimates that the rule will apply to approximately 25 national banking organizations. Thus, the estimate of the total administrative cost of the proposed rule is approximately $1.2 million. Thus, the estimated total cost of the proposed rule applied to ABS is $57.2 million.

The OCC has determined that its portion of the final rules will not result in expenditures by State, local, and tribal governments, or by the private sector, of $126.4 million or more. Accordingly, the OCC has not prepared a budgetary impact statement or specifically addressed the regulatory alternatives considered

F. Commission: Small Business Regulatory Enforcement Fairness Act

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"[237] the Commission solicits data to determine whether the proposal constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in:

- An annual effect on the economy of $100 million or more (either in the form of an increase or a decrease);
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effects on competition, investment or innovation.

We request comment on the potential impact of the proposal on the U.S. economy on an annual basis, any potential increase in costs or prices for consumers or individual industries, and any potential effect on competition, investment or innovation. Commenters are requested to provide empirical data and other factual support for their views if possible.

G. FHFA: Considerations of Differences between the Federal Home Loan Banks and the Enterprises

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[237] 5 U.S.C. 603.

Section 1313 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 requires the Director of FHFA, when promulgating regulations relating to the Federal Home Loan Banks (Banks), to consider the following differences between the Banks and the Enterprises (Fannie Mae and Freddie Mac): cooperative ownership structure; mission of providing liquidity to members; affordable housing and community development mission; capital structure; and joint and several liability.[238] The Director also may consider any other differences that are deemed appropriate. In preparing the portions of this proposed rule over which FHFA has joint rulemaking authority, the Director considered the differences between the Banks and the Enterprises as they relate to the above factors. FHFA requests comments from the public about whether differences related to these factors should result in any revisions to the proposal.

Text of the Proposed Common Rules

(All Agencies)

The text of the proposed common rules appears below:

PART [ ]—CREDIT RISK RETENTION

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[238] See 12 U.S.C. 4513.

Appendix Additional QRM Standards

SUBPART A—AUTHORITY, PURPOSE, SCOPE AND DEFINITIONS

§ __.1 Authority, purpose, and scope

[Reserved]

§ __.2 Definitions.

For purposes of this part, the following definitions apply:

ABCP means asset-backed commercial paper that has a maturity at the time of issuance not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

ABS interest:

(1) Includes any type of interest or obligation issued by an issuing entity, whether or not in certificated form, including a security, obligation, beneficial interest or residual interest, payments on which are primarily dependent on the cash flows of the collateral owned or held by the issuing entity; and

(2) Does not include common or preferred stock, limited liability interests, partnership interests, trust certificates, or similar interests that:

(i) Are issued primarily to evidence ownership of the issuing entity; and

(ii) The payments, if any, on which are not primarily dependent on the cash flows of the collateral held by the issuing entity.

An affiliate of, or a person affiliated with, a specified person means a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.

Asset means a self-liquidating financial asset (including but not limited to a loan, lease, mortgage, or receivable).

Asset-backed security has the same meaning as in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)).

Appropriate Federal banking agency has the same meaning as in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813).

Collateral with respect to any issuance of ABS interests means the assets or other property that provide the cash flow (including cash flow from the foreclosure or sale of the assets or property) for the ABS interests irrespective of the legal structure of issuance, including security interests in assets or other property of the issuing entity, fractional undivided property interests in the assets or other property of the issuing entity, or any other property interest in such assets or other property.

Assets or other property collateralize an issuance of ABS interests if the assets or property serve as collateral for such issuance.

Commercial real estate loan has the same meaning as in § __.16 of this part.

Commission means the Securities and Exchange Commission.

Consolidated affiliate means, with respect to a sponsor, an entity (other than the issuing entity) the financial statements of which are consolidated with those of:

(1) The sponsor under applicable accounting standards; or

(2) Another entity the financial statements of which are consolidated with those of the sponsor under applicable accounting standards.

Control including the terms "controlling," "controlled by" and "under common control with"

(1) Means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.

(2) Without limiting the foregoing, a person shall be considered to control a company if the person:

(i) Owns, controls or holds with power to vote 25 percent or more of any class of voting securities of the company; or

(ii) Controls in any manner the election of a majority of the directors, trustees or persons performing similar functions of the company.

Credit risk means:

(1) The risk of loss that could result from the failure of the borrower in the case of a securitized asset, or the issuing entity in the case of an ABS interest in the issuing entity, to make required payments of principal or interest on the asset or ABS interest on a timely basis;

(2) The risk of loss that could result from bankruptcy, insolvency, or a similar proceeding with respect to the borrower or issuing entity, as appropriate; or

(3) The effect that significant changes in the underlying credit quality of the asset or ABS interest may have on the market value of the asset or ABS interest.

Depositor means:

(1) The person that receives or purchases and transfers or sells the securitized assets to the issuing entity;

(2) The sponsor, in the case of a securitization transaction where there is not an intermediate transfer of the assets from the sponsor to the issuing entity; or

(3) The person that receives or purchases and transfers or sells the securitized assets to the issuing entity in the case of a securitization transaction where the person transferring or selling the securitized assets directly to the issuing entity is itself a trust.

Eligible ABCP conduit means an issuing entity that issues ABCP provided that:

(1) The issuing entity is bankruptcy remote or otherwise isolated for insolvency purposes from the sponsor of the issuing entity and from any intermediate SPV;

(2) The interests issued by an intermediate SPV to the issuing entity are collateralized solely by the assets originated by a single originator-seller;

(3) All of the interests issued by an intermediate SPV are transferred to one or more ABCP conduits or retained by the originator-seller; and

(4) A regulated liquidity provider has entered into a legally binding commitment to provide 100 percent liquidity coverage (in the form of a lending facility, an asset purchase agreement, a repurchase agreement, or other similar arrangement) to all the ABCP issued by the issuing entity by lending to, or purchasing assets from, the issuing entity in the event that funds are required to repay maturing ABCP issued by the issuing entity.

Eligible horizontal residual interest means, with respect to any securitization transaction, an ABS interest in the issuing entity that:

(1) Is allocated all losses on the securitized assets (other than losses that are first absorbed through the release of funds from a premium capture cash reserve account, if such an account is required to be established under § __.12 of this part) until the par value of such ABS interest is reduced to zero;

(2) Has the most subordinated claim to payments of both principal and interest by the issuing entity; and

(3) Until all other ABS interests in the issuing entity are paid in full, is not entitled to receive any payments of principal made on a securitized asset, provided, however, an eligible horizontal residual interest may receive its current proportionate share of scheduled payments of principal received on the securitized assets in accordance with the transaction documents.

Federal banking agencies means the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation.

Intermediate SPV means, with respect to an originator-seller, a special purpose vehicle that:

(1) Is bankruptcy remote or otherwise isolated for insolvency purposes from the originator-seller;

(2) Purchases assets from the originator-seller; and

(3) Issues interests collateralized by such assets to one or more ABCP conduits.

Issuing entity means, with respect to a securitization transaction, the trust or other entity:

(1) That is created at the direction of the sponsor;

(2) That owns or holds the pool of assets to be securitized; and

(3) In whose name the asset-backed securities are issued.

Originator means a person who:

(1) Through an extension of credit or otherwise, creates an asset that collateralizes an asset-backed security; and

(2) Sells the asset directly or indirectly to a securitizer.

Originator-seller means an entity that creates assets through one or more extensions of credit and sells those assets (and no other assets) to an intermediate SPV, which in turn sells interests collateralized by those assets to one or more ABCP conduits.

Regulated liquidity provider means:

(1) A depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813));

(2) A bank holding company (as defined in 12 U.S.C. 1841), or a subsidiary thereof;

(3) A savings and loan holding company (as defined in 12 U.S.C. 1467a), provided all or substantially all of the holding company's activities are permissible for a financial holding company under 12 U.S.C. 1843(k), or a subsidiary thereof; or

(4) A foreign bank whose home country supervisor (as defined in § 211.21 of the Federal Reserve Board's Regulation K (12 CFR 211.21)) has adopted capital standards consistent with the Capital Accord of the Basel Committee on Banking Supervision, as amended, and that is subject to such standards, or a subsidiary thereof.

Retaining sponsor means, with respect to a securitization transaction, the sponsor that has retained or caused to be retained an economic interest in the credit risk of the securitized assets pursuant to subpart B of this part.

Revolving asset master trust means an issuing entity that is:

(1) A master trust; and

(2) Established to issue more than one series of asset-backed securities all of which are collateralized by a single pool of revolving securitized assets that are expected to change in composition over time.

Securitization transaction means a transaction involving the offer and sale of asset-backed securities by an issuing entity.

Securitized asset means an asset that:

(1) Is transferred, sold, or conveyed to an issuing entity; and

(2) Collateralizes the ABS interests issued by the issuing entity.

Securitizer with respect to a securitization transaction shall mean either:

(1) The depositor of the asset-backed securities; or

(2) A sponsor of the asset-backed securities.

Seller's interest means an ABS interest:

(1) In all of the assets that:

(i) Are owned or held by the issuing entity; and

(ii) Do not collateralize any other ABS interests issued by the issuing entity;

(2) That is pari passu with all other ABS interests issued by the issuing entity with respect to the allocation of all payments and losses prior to an early amortization event (as defined in the transaction documents); and

(3) That adjusts for fluctuations in the outstanding principal balances of the securitized assets.

Servicer means any person responsible for the management or collection of the securitized assets or making allocations or distributions to holders of the ABS interests, but does not include a trustee for the issuing entity or the asset-backed securities that makes allocations or distributions to holders of the ABS interests if the trustee receives such allocations or distributions from a servicer and the trustee does not otherwise perform the functions of a servicer.

Sponsor means a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity.

U.S. person:

(1) Means—

(i) Any natural person resident in the United States;

(ii) Any partnership, corporation, limited liability company, or other organization or entity organized or incorporated under the laws of the United States;

(iii) Any estate of which any executor or administrator is a U.S. person;

(iv) Any trust of which any trustee is a U.S. person;

(v) Any agency or branch of a foreign entity located in the United States;

(vi) Any non-discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary for the benefit or account of a U.S. person;

(vii) Any discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary organized, incorporated, or (if an individual) resident in the United States; and

(viii) Any partnership, corporation, limited liability company, or other organization or entity if:

(A) Organized or incorporated under the laws of any foreign jurisdiction; and

(B) Formed by a U.S. person principally for the purpose of investing in securities not registered under the Act.

(2) Does not include—

(i) Any discretionary account or similar account (other than an estate or trust) held for the benefit or account of a non-U.S. person by a dealer or other professional fiduciary organized, incorporated, or (if an individual) resident in the United States;

(ii) Any estate of which any professional fiduciary acting as executor or administrator is a U.S. person if:

(A) An executor or administrator of the estate who is not a U.S. person has sole or shared investment discretion with respect to the assets of the estate; and

(B) The estate is governed by foreign law;

(iii) Any trust of which any professional fiduciary acting as trustee is a U.S. person, if a trustee who is not a U.S. person has sole or shared investment discretion with respect to the trust assets, and no beneficiary of the trust (and no settlor if the trust is revocable) is a U.S. person;

(iv) An employee benefit plan established and administered in accordance with the law of a country other than the United States and customary practices and documentation of such country;

(v) Any agency or branch of a U.S. person located outside the United States if:

(A) The agency or branch operates for valid business reasons; and

(B) The agency or branch is engaged in the business of insurance or banking and is subject to substantive insurance or banking regulation, respectively, in the jurisdiction where located;

(vi) The International Monetary Fund, the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the United Nations, and their agencies, affiliates and pension plans, and any other similar international organizations, their agencies, affiliates and pension plans.

(3) For purposes of the definition of a U.S. person, the term United States means the United States of America, its territories and possessions, any State of the United States, and the District of Columbia.

SUBPART B—CREDIT RISK RETENTION

§ __.3 Base risk retention requirement.

(a) Base risk retention requirement. Except as otherwise provided in this part, the sponsor of a securitization transaction shall retain an economic interest in the credit risk of the securitized assets in accordance with any one of § __.4 through § __.11 of this part.

(b) Multiple sponsors. If there is more than one sponsor of a securitization transaction, it shall be the responsibility of each sponsor to ensure that at least one of the sponsors of the securitization transaction retains an economic interest in the credit risk of the securitized assets in accordance with any one of § __.4 through § __.11 of this part.

§ __.4 Vertical risk retention.

(a) In general. At the closing of the securitization transaction, the sponsor retains not less than five percent of each class of ABS interests in the issuing entity issued as part of the securitization transaction.

(b) Disclosures. A sponsor utilizing this section shall provide, or cause to be provided, to potential investors a reasonable period of time prior to the sale of the asset-backed securities in the securitization transaction and, upon request, to the Commission and to its appropriate Federal banking agency, if any, the following disclosure in written form under the caption "Credit Risk Retention":

(1) The amount (expressed as a percentage and dollar amount) of each class of ABS interests in the issuing entity that the sponsor will retain (or did retain) at the closing of the securitization transaction and the amount (expressed as a percentage and dollar amount) of each class of ABS interests in the issuing entity that the sponsor is required to retain under this section; and

(2) The material assumptions and methodology used in determining the aggregate dollar amount of ABS interests issued by the issuing entity in the securitization transaction, including those pertaining to any estimated cash flows and the discount rate used.

§ __.5 Horizontal risk retention.

(a) General requirement. At the closing of the securitization transaction, the sponsor retains an eligible horizontal residual interest in an amount that is equal to at least five percent of the par value of all ABS interests in the issuing entity issued as part of the securitization transaction.

(b) Option to hold base amount in horizontal cash reserve account. In lieu of retaining an eligible horizontal residual interest in the amount required by paragraph (a) of this section, the sponsor may, at closing of the securitization transaction, cause to be established and funded, in cash, a horizontal cash reserve account in the amount specified in paragraph (a), provided that the account meets all of the following conditions:

(1) The account is held by the trustee (or person performing similar functions) in the name and for the benefit of the issuing entity;

(2) Amounts in the account are invested only in:

(i) United States Treasury securities with maturities of 1 year or less; or

(ii) Deposits in one or more insured depository institutions (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)) that are fully insured by federal deposit insurance; and

(3) Until all ABS interests in the issuing entity are paid in full or the issuing entity is dissolved:

(i) Amounts in the account shall be released to satisfy payments on ABS interests in the issuing entity on any payment date on which the issuing entity has insufficient funds from any source (including any premium capture cash reserve account established pursuant to § __.12 of this part) to satisfy an amount due on any ABS interest; and

(ii) No other amounts may be withdrawn or distributed from the account except that:

(A) Amounts in the account may be released to the sponsor or any other person due to the receipt by the issuing entity of scheduled payments of principal on the securitized assets, provided that, the issuing entity distributes such payments of principal in accordance with the transaction documents and the amount released from the account on any date does not exceed the product of:

(1) The amount of scheduled payments of principal received by the issuing entity and for which the release is being made; and

(2) The ratio of the current balance in the horizontal cash reserve account to the aggregate remaining principal balance of all ABS interests in the issuing entity; and

(B) Interest on investments made in accordance with paragraph (b)(2) may be released once received by the account.

(c) Disclosures. A sponsor utilizing this section shall provide, or cause to be provided, to potential investors a reasonable period of time prior to the sale of the asset-backed securities in the securitization transaction and, upon request, to the Commission and its appropriate Federal banking agency, if any, the following disclosure in written form under the caption "Credit Risk Retention":

(1) If the sponsor retains risk through an eligible horizontal residual interest:

(i) The amount (expressed as a percentage and dollar amount) of the eligible horizontal residual interest the sponsor will retain (or did retain) at the closing of the securitization transaction, and the amount (expressed as a percentage and dollar amount) of the eligible horizontal residual interest that the sponsor is required to retain under this section; and

(ii) A description of the material terms of the eligible horizontal residual interest to be retained by the sponsor;

(2) If the sponsor retains risk through the funding of a horizontal cash reserve account:

(i) The dollar amount to be placed (or placed) by the sponsor in the horizontal cash reserve account and the dollar amount the sponsor is required to place in such an account pursuant to this section; and

(ii) A description of the material terms of the horizontal cash reserve account; and

(3) The material assumptions and methodology used in determining the aggregate dollar amount of ABS interests issued by the issuing entity in the securitization transaction, including those pertaining to any estimated cash flows and the discount rate used.

§ __.6 L-Shaped risk retention.

(a) General requirement. At the closing of the securitization transaction, the sponsor:

(1) Retains not less than 2.5 percent of each class of ABS interests in the issuing entity issued as part of the securitization transaction; and

(2) Retains an eligible horizontal residual interest in the issuing entity, or establishes and funds in cash a horizontal cash reserve account that meets all of the requirements of § __.5(b) of this part, in an amount that in either case is equal to at least 2.564 percent of the par value of all ABS interests in the issuing entity issued as part of the securitization transaction other than any portion of such ABS interests that the sponsor is required to retain pursuant to paragraph (a)(1) of this section.

(b) Disclosure requirements. A sponsor utilizing this section shall comply with all of the disclosure requirements set forth in § __.4(b) and § __.5(c) of this part.

§ __.7 Revolving asset master trusts.

(a) General requirement. At the closing of the securitization transaction and until all ABS interests in the issuing entity are paid in full, the sponsor retains a seller's interest of not less than five percent of the unpaid principal balance of all the assets owned or held by the issuing entity provided that:

(1) The issuing entity is a revolving asset master trust; and

(2) All of the securitized assets are loans or other extensions of credit that arise under revolving accounts.

(b) Disclosures. A sponsor utilizing this section shall provide, or cause to be provided, to potential investors a reasonable period of time prior to the sale of the asset-backed securities in the securitization transaction and, upon request, to the Commission and its appropriate Federal banking agency, if any, the following disclosure in written form under the caption "Credit Risk Retention":

(1) The amount (expressed as a percentage and dollar amount) of the seller's interest that the sponsor will retain (or did retain) at the closing of the securitization transaction and the amount (expressed as a percentage and dollar amount) that the sponsor is required to retain pursuant to this section;

(2) A description of the material terms of the seller's interest; and

(3) The material assumptions and methodology used in determining the aggregate dollar amount of ABS interests issued by the issuing entity in the securitization transaction, including those pertaining to any estimated cash flows and the discount rate used.

§ __.8 Representative sample.

(a) In general. At the closing of the securitization transaction, the sponsor retains ownership of a representative sample of the pool of assets that are designated for securitization in the securitization transaction and draws from such pool all of the securitized assets for the securitization transaction, provided that:

(1) At the time of issuance of asset-backed securities by the issuing entity, the unpaid principal balance of the assets comprising the representative sample retained by

the sponsor is equal to at least 5.264 percent of the unpaid principal balance of all the securitized assets in the securitization transaction; and

(2) The sponsor complies with paragraphs (b) through (g) of this section.

(b) Construction of representative sample.

(1) Designated pool. Prior to the sale of the asset-backed securities as part of the securitization transaction, the sponsor identifies a designated pool (the "designated pool") of assets:

(i) That consists of a minimum of 1000 separate assets;

(ii) From which the securitized assets and the assets comprising the representative sample are exclusively drawn; and

(iii) That contains no assets other than those described in paragraph (b)(1)(ii) of this section.

(2) Random selection from designated pool. (i) Prior to the sale of the asset-backed securities as part of the securitization transaction, the sponsor selects from the assets that comprise the designated pool a sample of such assets using a random selection process that does not take account of any characteristic of the assets other than the unpaid principal balance of the assets.

(ii) The unpaid principal balance of the assets selected through the random selection process described in paragraph (b)(2)(i) must represent at least 5 percent of the aggregate unpaid principal balance of all the assets that comprise the designated pool.

(3) Equivalent risk determination. Prior to the sale of the asset-backed securities as part of the securitization transaction, the sponsor determines, using a statistically valid methodology, that for each material characteristic of the assets in the designated pool,

including the average unpaid principal balance of all the assets, that the mean of any quantitative characteristic, and the proportion of any characteristic that is categorical in nature, of the sample of assets randomly selected from the designated pool pursuant to paragraph (b)(2) of this section is within a 95 percent two-tailed confidence interval of the mean or proportion, respectively, of the same characteristic of the assets in the designated pool.

(c) Sponsor policies, procedures and documentation.

(1) The sponsor has in place, and adheres to, policies and procedures for:

(i) Identifying and documenting the material characteristics of assets included in the designated pool;

(ii) Selecting assets randomly in accordance with paragraph (b)(2) of this section;

(iii) Testing the randomly-selected sample of assets for compliance with paragraph (b)(3) of this section;

(iv) Maintaining, until all ABS interests are paid in full, documentation that clearly identifies the assets included in the representative sample established under paragraphs (b)(2) and (3) of this section; and

(v) Prohibiting, until all ABS interests are paid in full, assets in the representative sample from being included in the designated pool of any other securitization transaction.

(2) The sponsor maintains documentation that clearly identifies the assets in the representative sample established under paragraphs (b)(2) and (3) of this section.

(d) Agreed upon procedures report.

(1) Prior to the sale of the asset-backed securities as part of the securitization transaction, the sponsor has obtained an agreed upon procedures report that satisfies the

requirements of paragraph (d)(2) of this section from an independent public accounting firm.

(2) The independent public accounting firm providing the agreed upon procedures report required by paragraph (d)(1) of this section must at a minimum report on whether the sponsor has:

(i) Policies and procedures that require the sponsor to identify and document the material characteristics of assets included in a designated pool of assets that meets the requirements of paragraph (b)(1) of this section;

(ii) Policies and procedures that require the sponsor to select assets randomly in accordance with paragraph (b)(2) of this section;

(iii) Policies and procedures that require the sponsor to test the randomly-selected sample of assets in accordance with paragraph (b)(3) of this section;

(iv) Policies and procedures that require the sponsor to maintain, until all ABS interests are paid in full, documentation that identifies the assets in the representative sample established under paragraphs (b)(2) and (3) of this section; and

(v) Policies and procedures that require the sponsor to prohibit, until all ABS interests are paid in full, assets in the representative sample from being included in the designated pool of any other securitization transaction.

(e) Servicing. Until such time as all ABS interests in the issuing entity have been fully paid or the issuing entity has been dissolved:

(1) Servicing of the assets included in the representative sample must be conducted by the same entity and under the same contractual standards as the servicing of the securitized assets; and

(2) The individuals responsible for servicing the assets included in the representative sample or the securitized assets must not be able to determine whether an asset is owned or held by the sponsor or owned or held by the issuing entity.

(f) Sale, hedging or pledging prohibited. Until such time as all ABS interests in the issuing entity have been fully paid or the issuing entity has been dissolved, the sponsor:

(1) Shall comply with the restrictions in § __.14 of this part with respect to the assets in the representative sample;

(2) Shall not remove any assets from the representative sample; and

(3) Shall not cause or permit any assets in the representative sample to be included in any designated pool or representative sample established in connection with any other issuance of asset-backed securities.

(g) Disclosures.

(1) Disclosure prior to sale. A sponsor utilizing this section shall provide, or cause to be provided, to potential investors a reasonable period of time prior to the sale of the asset-backed securities as part of the securitization transaction and, upon request, to the Commission and its appropriate Federal banking agency, if any, the following disclosure with respect to the securitization transaction in written form under the caption "Credit Risk Retention":

(i) The amount (expressed as a percentage of the designated pool and dollar amount) of assets included in the representative sample and to be retained (or retained) by the sponsor, and the amount (expressed as a percentage of the designated pool and dollar amount) of assets required to be included in the representative sample and retained by the sponsor pursuant to this section;

(ii) A description of the material characteristics of the designated pool, including, but not limited to, the average unpaid principal balance of all the assets, the means of the quantitative characteristics and the proportions of categorical characteristics of the assets, appropriate introductory and explanatory information to introduce the characteristics, the methodology used in determining or calculating the characteristics, and any terms or abbreviations used;

(iii) A description of the policies and procedures that the sponsor used for ensuring that the process for identifying the representative sample complies with paragraph (b)(2) of this section and that the representative sample has equivalent material characteristics as required by paragraph (b)(3) of this section;

(iv) Confirmation that an agreed upon procedures report was obtained pursuant to paragraph (d) of this section; and

(v) The material assumptions and methodology used in determining the aggregate dollar amount of ABS interests issued by the issuing entity in the securitization transaction, including those pertaining to any estimated cash flows and the discount rate used.

(2) Disclosure after sale. A sponsor utilizing this section shall provide, or cause to be provided, to the holders of the asset-backed securities issued as part of the securitization transaction and, upon request, provide, or cause to be provided, to the Commission and its appropriate Federal banking agency, if any, at the end of each distribution period, as specified in the governing documents for such asset-backed

securities, a comparison of the performance of the pool of securitized assets included in the securitization transaction for the related distribution period with the performance of the assets in the representative sample for the related distribution period.

(3) Conforming disclosure of representative sample. A sponsor utilizing this section shall provide, or cause to be provided, to holders of the asset-backed securities issued as part of the securitization transaction and, upon request, provide to the Commission and its appropriate Federal banking agency, if any, disclosure concerning the assets in the representative sample in the same form, level, and manner as it provides, pursuant to rule or otherwise, concerning the securitized assets.

§ __.9 Eligible ABCP conduits.

(a) In general. A sponsor satisfies the risk retention requirement of § __.3 of this part with respect to the issuance of ABCP by an eligible ABCP conduit in a securitization transaction if:

(1) Each originator-seller of the ABCP conduit:

(i) Retains an eligible horizontal residual interest in each intermediate SPV established by or on behalf of that originator-seller for purposes of issuing interests collateralized by assets of such intermediate SPV to the eligible ABCP conduit in the same form, amount, and manner as would be required under §__.5(a) of this part if the originator-seller was the only sponsor of the intermediate SPV; and

(ii) Complies with the provisions of § __.14 of this part with respect to the eligible horizontal residual interest retained pursuant to paragraph (a)(1)(i) of this section as if it were a retaining sponsor with respect to such interest;

(2) The sponsor:

(i) Establishes the eligible ABCP conduit;

(ii) Approves each originator-seller permitted to sell or transfer assets, indirectly through an intermediate SPV, to the eligible ABCP conduit;

(iii) Establishes criteria governing the assets that the originator-sellers referred to in paragraph (a)(2)(ii) of this section are permitted to sell or transfer to an intermediate SPV;

(iv) Approves all interests in an intermediate SPV to be purchased by the eligible ABCP conduit;

(v) Administers the eligible ABCP conduit by monitoring the interests in any intermediate SPV acquired by the conduit and the assets collateralizing those interests, arranging for debt placement, compiling monthly reports, and ensuring compliance with the conduit documents and with the conduit's credit and investment policy; and

(vi) Maintains and adheres to policies and procedures for ensuring that the conditions in this paragraph (a) have been met.

(b) Disclosures. A sponsor utilizing this section shall provide, or cause to be provided, to potential investors a reasonable period of time prior to the sale of any ABCP by the eligible ABCP conduit as part of the securitization transaction and, upon request, to the Commission and its appropriate Federal banking agency, if any, in written form under the caption "Credit Risk Retention", the name and form of organization of:

(1) Each originator-seller that will retain (or has retained) an eligible horizontal residual interest in the securitization transaction pursuant to this section, including a description of the form, amount (expressed as a percentage and as a dollar amount), and nature of such interest; and

(2) Each regulated liquidity provider that provides liquidity support to the eligible ABCP conduit, including a description of the form, amount, and nature of such liquidity coverage.

(c) Duty to comply.

(1) The retaining sponsor shall be responsible for compliance with this section.

(2) A retaining sponsor relying on this section:

(i) Shall maintain and adhere to policies and procedures that are reasonably designed to monitor compliance by each originator-seller of the eligible ABCP conduit with the requirements of paragraph (a)(1) of this section; and

(ii) In the event that the sponsor determines that an originator-seller no longer complies with the requirements of paragraph (a)(1) of this section, shall promptly notify the holders of the ABS interests issued in the securitization transaction of such noncompliance by such originator-seller.

§ ___.10 Commercial mortgage-backed securities.

(a) Third-Party Purchaser. A sponsor satisfies the risk retention requirements of § ___.3 of this part with respect to a securitization transaction if a third party purchases an eligible horizontal residual interest in the issuing entity in the same form, amount, and manner as would be required of the sponsor under § ___.5(a) of this part and all of the following conditions are met:

(1) Composition of collateral. At the closing of the securitization transaction, at least 95 percent of the total unpaid principal balance of the securitized assets in the securitization transaction are commercial real estate loans.

(2) Source of funds. The third-party purchaser:

(i) Pays for the eligible horizontal residual interest in cash at the closing of the securitization transaction; and

(ii) Does not obtain financing, directly or indirectly, for the purchase of such interest from any other person that is a party to the securitization transaction (including, but not limited to, the sponsor, depositor, or an unaffiliated servicer), other than a person that is a party to the transaction solely by reason of being an investor.

(3) Third-party review. The third-party purchaser conducts a review of the credit risk of each securitized asset prior to the sale of the asset-backed securities in the securitization transaction that includes, at a minimum, a review of the underwriting standards, collateral, and expected cash flows of each commercial real estate loan that is collateral for the asset-backed securities.

(4) Affiliation and control rights. (i) Except as provided in paragraphs (a)(4)(ii) or (iii) of this section:

(A) The third-party purchaser is not affiliated with any party to the securitization transaction (including, but not limited to, the sponsor, depositor, or servicer) other than investors in the securitization transaction; and

(B) The third-party purchaser or an affiliate of such third-party purchaser does not have control rights in connection with the securitization transaction (including, but not limited to, acting as a servicer for the securitized assets) that are not collectively shared with all other investors in the securitization.

(ii) Notwithstanding paragraph (a)(4)(i)(A) of this section, the third-party purchaser may be affiliated with one or more originators of the securitized assets so long as the assets originated by the affiliated originator or originators collectively comprise less than 10 percent of the unpaid principal balance of the securitized assets included in the securitization transaction at closing of the securitization transaction.

(iii) Paragraph (a)(4)(i) of this section shall not prevent the third-party purchaser from acting as, or being an affiliate of, a servicer for any of the securitized assets, and having such controls rights that are related to such servicing, if the underlying securitization transaction documents provide for the following:

(A) The appointment of an operating advisor (the "Operating Advisor") that:

(1) Is not affiliated with other parties to the securitization transaction;

(2) Does not directly or indirectly have any financial interest in the securitization transaction other than in fees from its role as Operating Advisor; and

(3) Is required to act in the best interest of, and for the benefit of, investors as a collective whole.

(B) Any servicer for the securitized assets that is, or is affiliated with, the third-party purchaser must consult with the Operating Advisor in connection with, and prior to, any major decision in connection with the servicing of the securitized assets, including, without limitation:

(1) Any material modification of, or waiver with respect to, any provision of a loan agreement (including a mortgage, deed of trust, or other security agreement);

(2) Foreclosure upon or comparable conversion of the ownership of a property; or

(3) Any acquisition of a property.

(C) The Operating Advisor shall be responsible for reviewing the actions of any servicer that is, or is affiliated with, the third-party purchaser and for issuing a report to investors and the issuing entity on a periodic basis concerning:

(1) Whether the Operating Advisor believes, in its sole discretion exercised in good faith, that such servicer is operating in compliance with any standard required of the servicer as provided in the applicable transaction documents; and

(2) What, if any, standard(s) the Operating Advisor believes, in its sole discretion exercised in good faith, with which such servicer has failed to comply;

(D) The Operating Advisor shall have the authority to recommend that a servicer that is, or is affiliated with, a third-party purchaser be replaced by a successor servicer if the Operating Advisor determines, in its sole discretion exercised in good faith, that:

(1) The servicer that is, or is affiliated with, the third-party purchaser has failed to comply with a standard required of the servicer as provided in the transaction documents; and

(2) Such replacement would be in the best interest of the investors as a collective whole; and

(E) If a recommendation described in paragraph (a)(4)(iii)(D) of this section is made, the servicer that is, or is affiliated with, the third-party purchaser must be replaced unless a majority of each class of ABS interests in the issuing entity eligible to vote on the matter votes to retain the servicer.

(5) Disclosures. The sponsor provides, or causes to be provided, to potential investors a reasonable period of time prior to the sale of the asset-backed securities as part of the securitization transaction and, upon request, to the Commission and its appropriate Federal banking agency, if any, the following disclosure in written form, and, with respect to subparagraphs (i) through (vii), under the caption "Credit Risk Retention":

(i) The name and form of organization of the third-party purchaser;

(ii) A description of the third-party purchaser's experience in investing in commercial mortgage-backed securities;

(iii) Any other information regarding the third-party purchaser or the third-party purchaser's retention of the eligible horizontal residual interest that is material to investors in light of the circumstances of the particular securitization transaction;

(iv) A description of the amount (expressed as a percentage and dollar amount) of the eligible horizontal residual interest that will be retained (or was retained) by the third-party purchaser, as well as the amount of the purchase price paid by the third-party purchaser for such interest;

(v) The amount (expressed as a percentage and dollar amount) of the eligible horizontal residual interest in the securitization transaction that the sponsor would have been required to retain pursuant to § __.5(a) of this part if the sponsor had relied on such section to meet the requirements of §__.3 of this part with respect to the transaction;

(vi) A description of the material terms of the eligible residual horizontal interest retained by the third-party purchaser;

(vii) The material assumptions and methodology used in determining the aggregate amount of ABS interests issued by the issuing entity in the securitization transaction, including those pertaining to any estimated cash flows and the discount rate used; and

(viii) The representations and warranties concerning the securitized assets, a schedule of any securitized assets that are determined do not comply with such representations and warranties, and what factors were used to make the determination that such securitized assets should be included in the pool notwithstanding that the securitized assets did not comply with such representations and warranties, such as compensating factors or a determination that the exceptions were not material.

(6) Hedging, transfer and pledging. The third-party purchaser complies with the hedging and other restrictions in § __.14 of this part as if it were the retaining sponsor with respect to the securitization transaction and had acquired the eligible horizontal residual interest pursuant to § __.5 of this part.

(b) Duty to comply.

(1) The retaining sponsor shall be responsible for compliance with this section..

(2) A retaining sponsor relying on this section:

(A) Shall maintain and adhere to policies and procedures to monitor the third-party purchaser's compliance with the requirements in paragraph (a) of this section (other than paragraphs (a)(1) and (a)(5)); and

(B) In the event that the sponsor determines that the third-party purchaser no longer complies with any of the requirements of paragraph (a) of this section (other than paragraphs (a)(1) and (a)(5)), shall promptly notify, or cause to be notified, the holders of the ABS interests issued in the securitization transaction of such noncompliance by the third-party purchaser.

§ __.11 Federal National Mortgage Association and Federal Home Loan Mortgage Corporation ABS.

(a) In general. The sponsor fully guarantees the timely payment of principal and interest on all ABS interests issued by the issuing entity in the securitization transaction and is:

(1) The Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation operating under the conservatorship or receivership of the Federal Housing Finance Agency pursuant to section 1367 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4617) with capital support from the United States; or

(2) Any limited-life regulated entity succeeding to the charter of either the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation pursuant to section 1367(i) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4617(i)), provided that the entity is operating with capital support from the United States.

(b) Certain provisions not applicable. The provisions of §__.12 and §__.14(b), (c), and (d) of this part shall not apply to a sponsor described in paragraph (a)(1) or (2) of this section, its affiliates, or the issuing entity with respect to a securitization transaction for which the sponsor has retained credit risk in accordance with the requirements of this section.

(c) Disclosure. A sponsor utilizing this section shall provide to investors, in written form under the caption "Credit Risk Retention" and, upon request, to the Federal Housing Finance Agency and the Commission, a description of the manner in which it has met the credit risk retention requirements of this part.

§____.12 Premium capture cash reserve account.

(a) When creation of a premium capture cash reserve account is required and calculation of amount. In addition to the economic interest in the credit risk that a retaining sponsor is required to retain, or cause to be retained under §__.3 of this part, the retaining sponsor shall, at closing of the securitization transaction, cause to be established and funded, in cash, a premium capture cash reserve account (as defined in paragraph (b) of this section) in an amount equal to the difference, if a positive amount, between:

(1) The gross proceeds, net of closing costs paid by the sponsor(s) or issuing entity to unaffiliated parties, received by the issuing entity from the sale of ABS interests in the issuing entity to persons other than the retaining sponsor; and

(2) (i) If the retaining sponsor has relied on § __.4, § __.5, § __.6, or § __.7 of this part with respect to the securitization transaction, 95 percent of the par value of all ABS interests in the issuing entity issued as part of the securitization transaction; or

(ii) If the retaining sponsor has relied on § __.8, § __.9, or § __.10 of this part with respect to the securitization transaction, 100 percent of the par value of all ABS interests in the issuing entity issued as part of the securitization transaction.

(b) Operation of premium capture cash reserve account. For purposes of this section, a premium capture cash reserve account means an account that meets all of the following conditions:

(1) The account is held by the trustee (or person performing similar functions) in the name and for the benefit of the issuing entity;

(2) Amounts in the account may be invested only in:

(A) United States Treasury securities with maturities of 1 year or less; and

(B) Deposits in one or more insured depository institutions (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)) that are fully insured by federal deposit insurance; and

(3) Until all ABS interests in the issuing entity are paid in full or the issuing entity is dissolved, no funds may be withdrawn or distributed from the account except as follows:

(i) Amounts in the account shall be released to satisfy payments on ABS interests in the issuing entity on any payment date on which the issuing entity has insufficient funds to satisfy an amount due on an ABS interest prior to the allocation of any losses to:

(A) An eligible horizontal residual interest held pursuant to § __.5, §__.6, §__.9, §__.10, or §__.13 of this part, if any; or

(B) If an eligible horizontal residual interest in the issuing entity is not held pursuant to § __.5, §__.6, §__.9, §__.10, or §__.13 of this part, the class of ABS interests in the issuing entity that:

(1) Is allocated losses before other classes; or

(2) If the contractual terms of the securitization transaction do not provide for the allocation of losses by class, the class of ABS interests that has the most subordinate claim to payment of principal or interest by the issuing entity; and

(ii) Interest on investments made in accordance with paragraph (b)(2) of this section may be released to any person once received by the account.

(c) Calculation of gross proceeds received by issuing entity.

(1) Anti-evasion provision for certain resales and senior excess spread tranches. For purposes of paragraph (a)(1) of this section, the gross proceeds received by the issuing entity from the sale of ABS interests to persons other than the retaining sponsor shall include the par value, or if an ABS interest does not have a par value, the fair value,

of any ABS interest in the issuing entity that is directly or indirectly transferred to the retaining sponsor in connection with the closing of the securitization transaction and that:

(i) The retaining sponsor does not intend to hold to maturity; or

(ii) Represents a contractual right to receive some or all of the interest and no more than a minimal amount of principal payments received by the issuing entity and that has priority of payment of interest (or principal, if any) senior to the most subordinated class of ABS interests in the issuing entity, provided, however, this paragraph (c)(1)(ii) shall not apply to any ABS interest that:

(A) Does not have a par value;

(B) Is held by a sponsor that is relying on § __.4 or § __.6 of this part with respect to the securitization transaction; and

(C) The sponsor is required to retain pursuant to § __.4 or § __.6(a)(1) of this part.

(d) Disclosures. A sponsor that is required to establish and fund a premium capture cash reserve account pursuant to this section shall provide, or cause to be provided, to potential investors a reasonable period of time prior to the sale of the asset-backed securities as part of the securitization transaction and, upon request, to the Commission and its appropriate Federal banking agency, if any, the following disclosure in written form under the caption "Credit Risk Retention":

(1) The dollar amount required to be placed in the account pursuant to this section and any other amounts the sponsor will place (or has placed) in the account in connection with the securitization transaction; and

(2) The material assumptions and methodology used in determining the fair value of any ABS interest in the issuing entity that does not have a par value and that was used

in calculating the amount required for the premium capture cash reserve account pursuant to paragraph (c).

SUBPART C—TRANSFER OF RISK RETENTION

§ __.13 Allocation of risk retention to an originator.

(a) In general. A sponsor choosing to retain a portion of each class of ABS interests in the issuing entity under the vertical risk retention option in § __.4 of this part or an eligible horizontal residual interest pursuant to § __.5(a) of this part with respect to a securitization transaction may offset the amount of its risk retention requirements under § __.4 or § __.5(a) of this part, as applicable, by the amount of the ABS interests or eligible horizontal residual interest, respectively, acquired by an originator of one or more of the securitized assets if:

(1) Amount of retention. At the closing of the securitization transaction:

(i) The originator acquires and retains the ABS interests or eligible horizontal residual interest from the sponsor in the same manner as would have been retained by the sponsor under § __.4 or § __.5(a) of this part, as applicable;

(ii) The ratio of the dollar amount of ABS interests or eligible horizontal residual interest acquired and retained by the originator to the total dollar amount of ABS interests or eligible horizontal residual interest otherwise required to be retained by the sponsor pursuant to § __.4 or § __.5(a) of this part, as applicable, does not exceed the ratio of:

(A) The unpaid principal balance of all the securitized assets originated by the originator; to

(B) The unpaid principal balance of all the securitized assets in the securitization transaction;

(iii) The originator acquires and retains at least 20 percent of the aggregate risk retention amount otherwise required to be retained by the sponsor pursuant to § __.4 or § __.5(a) of this part, as applicable; and

(iv) The originator purchases the ABS interests or eligible horizontal residual interest from the sponsor at a price that is equal, on a dollar-for-dollar basis, to the amount by which the sponsor's required risk retention is reduced in accordance with this section, by payment to the sponsor in the form of:

(A) Cash; or

(B) A reduction in the price received by the originator from the sponsor or depositor for the assets sold by the originator to the sponsor or depositor for inclusion in the pool of securitized assets.

(2) Disclosures. In addition to the disclosures required pursuant to § __.4(b) or § __.5(c) of this part, the sponsor provides, or causes to be provided, to potential investors a reasonable period of time prior to the sale of the asset-backed securities as part of the securitization transaction and, upon request, to the Commission and its appropriate Federal banking agency, if any, in written form under the caption "Credit Risk Retention", the name and form of organization of any originator that will acquire and retain (or has acquired and retained) an interest in the transaction pursuant to this section, including a description of the form, amount (expressed as a percentage and dollar amount), and nature of the interest, as well as the method of payment for such interest under paragraph (a)(1)(iv).

(3) Hedging, transferring and pledging. The originator complies with the hedging and other restrictions in § __.14 of this part with respect to the interests retained by the

originator pursuant to this section as if it were the retaining sponsor and was required to retain the interest under subpart B of this part.

(b) Duty to comply.

(1) The retaining sponsor shall be responsible for compliance with this section.

(2) A retaining sponsor relying on this section:

(A) Shall maintain and adhere to policies and procedures that are reasonably designed to monitor the compliance by each originator that is allocated a portion of the sponsor's risk retention obligations with the requirements in paragraphs (a)(1) and (a)(3) of this section; and

(B) In the event the sponsor determines that any such originator no longer complies with any of the requirements in paragraphs (a)(1) and (a)(3) of this section, shall promptly notify, or cause to be notified, the holders of the ABS interests issued in the securitization transaction of such noncompliance by such originator.

§ __.14. Hedging, transfer and financing prohibitions.

(a) Transfer. A retaining sponsor may not sell or otherwise transfer any interest or assets that the sponsor is required to retain pursuant to subpart B of this part to any person other than an entity that is and remains a consolidated affiliate.

(b) Prohibited hedging by sponsor and affiliates. A retaining sponsor and its consolidated affiliates may not purchase or sell a security, or other financial instrument, or enter into an agreement, derivative or other position, with any other person if:

(1) Payments on the security or other financial instrument or under the agreement, derivative, or position are materially related to the credit risk of one or more particular ABS interests, assets, or securitized assets that the retaining sponsor is required to retain

with respect to a securitization transaction pursuant to subpart B of this part or one or more of the particular securitized assets that collateralize the asset-backed securities issued in the securitization transaction; and

(2) The security, instrument, agreement, derivative, or position in any way reduces or limits the financial exposure of the sponsor to the credit risk of one or more of the particular ABS interests, assets, or securitized assets that the retaining sponsor is required to retain with respect to a securitization transaction pursuant to subpart B of this part or one or more of the particular securitized assets that collateralize the asset-backed securities issued in the securitization transaction.

(c) Prohibited hedging by issuing entity. The issuing entity in a securitization transaction may not purchase or sell a security or other financial instrument, or enter into an agreement, derivative or position, with any other person if:

(1) Payments on the security or other financial instrument or under the agreement, derivative or position are materially related to the credit risk of one or more particular interests, assets, or securitized assets that the retaining sponsor for the transaction is required to retain with respect to the securitization transaction pursuant to subpart B of this part; and

(2) The security, instrument, agreement, derivative, or position in any way reduces or limits the financial exposure of the retaining sponsor to the credit risk of one or more of the particular interests or assets that the sponsor is required to retain pursuant to subpart B of this part.

(d) Permitted hedging activities. The following activities shall not be considered prohibited hedging activities by a retaining sponsor, a consolidated affiliate or an issuing entity under paragraph (b) or (c) of this section:

(1) Hedging the interest rate risk (which does not include the specific interest rate risk, known as spread risk, associated with the ABS interest that is otherwise considered part of the credit risk) or foreign exchange risk arising from one or more of the particular ABS interests, assets, or securitized assets required to be retained by the sponsor under subpart B of this part or one or more of the particular securitized assets that underlie the asset-backed securities issued in the securitization transaction; or

(2) Purchasing or selling a security or other financial instrument or entering into an agreement, derivative, or other position with any third party where payments on the security or other financial instrument or under the agreement, derivative, or position are based, directly or indirectly, on an index of instruments that includes asset-backed securities if:

(i) Any class of ABS interests in the issuing entity that were issued in connection with the securitization transaction and that are included in the index represents no more than 10 percent of the dollar-weighted average of all instruments included in the index; and

(ii) All classes of ABS interests in all issuing entities that were issued in connection with any securitization transaction in which the sponsor was required to retain an interest pursuant to subpart B of this part and that are included in the index represent, in the aggregate, no more than 20 percent of the dollar-weighted average of all instruments included in the index.

(e) Prohibited non-recourse financing. Neither a retaining sponsor nor any of its consolidated affiliates may pledge as collateral for any obligation (including a loan, repurchase agreement, or other financing transaction) any interest or asset that the sponsor is required to retain with respect to a securitization transaction pursuant to subpart B of this part unless such obligation is with full recourse to the sponsor or consolidated affiliate, respectively.

SUBPART D—EXCEPTIONS AND EXEMPTIONS

§ ___.15 Exemption for qualified residential mortgages.

(a) Definitions. For purposes of this section, the following definitions shall apply:

Borrower includes any co-borrower, unless the context otherwise requires.

Borrower funds means funds:

(1) Derived from one or more sources identified as acceptable sources of funds in the Additional QRM Standards Appendix to this part; and

(2) That are verified in accordance with the requirements set forth in the Additional QRM Standards Appendix to this part.

Cash-out refinancing means a refinancing transaction in a principal amount that exceeds the sum of the amount used to:

(1) Fully repay the balance outstanding on the borrower's existing first-lien mortgage that is secured by the one-to-four family property being refinanced;

(2) Fully repay the balance outstanding as of the date of the mortgage transaction on any subordinate-lien mortgage that was used in its entirety to purchase such one-to-four family property;

(3) Pay closing or settlement charges required to be included on the related HUD-1 or HUD-1A Settlement Statement or a successor form in accordance with 24 CFR Part 3500 or a successor regulation; and

(4) Disburse up to $500 of cash to the borrower or any other payee.

Closed-end credit means any consumer credit extended by a creditor other than open-end credit.

Combined loan-to-value ratio means, with respect to a first-lien refinancing transaction on a one-to-four family property, the ratio (expressed as a percentage) of:

(1) The sum of:

(i) The principal amount of the first-lien mortgage transaction at the closing of the transaction;

(ii) The unpaid principal amount of any other closed-end credit transaction that to the creditor's knowledge would exist at the closing of the refinancing transaction and that is or would be secured by the same one-to-four family property; and

(iii) The face amount (as if fully drawn) of any open-end credit transaction that to the creditor's knowledge would exist at the closing of the refinancing transaction and that is or would be secured by the same one-to-four family property; to

(2) The estimated market value of the one-to-four family property as determined by a qualifying appraisal.

Consumer credit means credit offered or extended to a borrower primarily for personal, family, or household purposes.

Consumer reporting agency that compiles and maintains files on consumers on a nationwide basis has the same meaning as in 15 U.S.C. 1681a(p).

Creditor has the same meaning as in 15 U.S.C. 1602(f).

Currently performing means the borrower in the mortgage transaction is not currently thirty (30) days past due, in whole or in part, on the mortgage transaction.

Loan-to-value ratio means, with respect to a mortgage transaction to purchase a one-to-four family property, the ratio (expressed as a percentage) of:

(1) The principal amount of the first-lien mortgage transaction at the closing of the mortgage transaction; to

(2) The lesser of:

(i) The estimated market value of the one-to-four family property as determined by a qualifying appraisal; and

(ii) The purchase price of the one-to-four family property to be paid in connection with the mortgage transaction.

Mortgage originator has the same meaning as in 15 U.S.C. 1602(cc)(2) and the regulations issued thereunder.

Mortgage transaction means a closed-end credit transaction to purchase or refinance a one-to-four family property at least one unit of which is the borrower's principal dwelling.

One-to-four family property means real property that is held in fee simple, on leasehold under a lease for not less than 99 years which is renewable, or under a lease having a period of not less than 10 years to run beyond the maturity date of the mortgage and that is improved by a residential structure that contains one to four units, including but not limited to: (1) An individual condominium; (2) An individual cooperative unit; or (3) An individual manufactured home that is constructed in conformance with the

National Manufactured Home Construction and Safety Standards, as evidenced by a certification label affixed to the exterior of the home, and that is erected on or that otherwise is affixed to a foundation in accordance with requirements established by the Federal Housing Administration.

Open-end credit means any consumer credit extended by a creditor under a plan in which:

(1) The creditor reasonably contemplates repeated consumer credit transactions;

(2) The creditor may impose a finance charge from time to time on an outstanding unpaid balance; and

(3) The amount of credit that may be extended to the borrower during the term of the plan (up to any limit set by the creditor) is generally made available to the extent that any outstanding balance is repaid.

Points and fees means:

(1) All items considered to be a finance charge under 12 CFR 226.4(a) and 226.4(b), except:

(i) Interest or the time-price differential; and

(ii) Items excluded from the finance charge under 12 CFR 226.4(c), 226.4(d) and 226.4(e), unless included in paragraphs (2) through (5) below;

(2) All compensation paid directly or indirectly by the borrower or creditor to a mortgage originator, including a mortgage originator that is also the creditor in a table-funded transaction;

(3) All items (other than amounts held for future payment of taxes) listed in section 12 CFR 226.4(c)(7) unless:

(i) The charge is bona fide and reasonable;

(ii) The creditor and mortgage originator receive no direct or indirect compensation in connection with the charge; and

(iii) The charge is not paid to an affiliate of the creditor or mortgage originator;

(4) Premiums or other charges payable at or before closing for any credit life, credit disability, credit unemployment, or credit property insurance, or any other accident, loss-of-income, life or health insurance, or any payments directly or indirectly for any debt cancellation or suspension agreement or contract; and

(5) If the mortgage transaction refinances a previous loan made or currently held by the same creditor or an affiliate of the same creditor, all prepayment fees or penalties that are incurred by the consumer in connection with the payment of the previous loan.

Prepayment penalty means a penalty imposed solely because the mortgage obligation is prepaid in full or in part. For purposes of this definition, a prepayment penalty does not include, for example, fees imposed for preparing and providing documents in connection with prepayment, such as a loan payoff statement, a reconveyance, or other document releasing the creditor's security interest in the one-to-four family property securing the loan.

Principal dwelling means a one-to-four family property, or unit thereof, that is occupied or will be occupied by at least one borrower as a principal residence. For purposes of this definition, a borrower can only have one principal dwelling at a time; however, if a borrower buys a new dwelling that will become the borrower's principal dwelling within a year or upon the completion of construction, the new dwelling is considered the principal dwelling for purposes of applying this definition to a credit transaction to purchase the new dwelling.

Qualifying appraisal means an appraisal that meets the requirements of § __.15(d)(11) of this part.

Rate and term refinancing means a refinancing transaction that is not a cash-out refinancing.

Refinancing transaction means:

(1) A closed-end credit transaction secured by a one-to-four family property that is entered into by the borrower that satisfies and replaces an existing credit transaction that was entered into by the same borrower and that is secured by the same one-to-four family property; or

(2) A closed-end credit transaction secured by the borrower's principal dwelling on which there are no existing liens.

Reverse mortgage means a nonrecourse consumer credit transaction in which:

(1) A mortgage, deed of trust, or equivalent consensual security interest securing one or more advances is created in the borrower's principal dwelling; and

(2) Any principal, interest, or shared appreciation or equity is due and payable (other than in the case of default) only after:

(i) The borrower dies;

(ii) The dwelling is transferred; or

(iii) The borrower ceases to occupy the one-to-four family property as a principal dwelling.

Total loan amount means the amount financed, as determined according to 12 CFR 226.18(b), less any cost listed in paragraphs (3), (4) and (5) of the definition of "points of fees" that is both included in the definition of points and fees and financed by the creditor.

(b) Exemption. A sponsor shall be exempt from the risk retention requirements in subpart B of this part with respect to any securitization transaction, if:

(1) All of the securitized assets that collateralize the asset-backed securities are qualified residential mortgages;

(2) None of the securitized assets that collateralize the asset-backed securities are other asset-backed securities;

(3) At the closing of the securitization transaction, each qualified residential mortgage collateralizing the asset-backed securities is currently performing; and

(4) (i) The depositor of the asset-backed security certifies that it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all assets that collateralize the asset-backed security are qualified residential mortgages and has concluded that its internal supervisory controls are effective;

(ii) The evaluation of the effectiveness of the depositor's internal supervisory controls referenced in paragraph (b)(4)(i) of this section shall be performed, for each issuance of an asset-backed security in reliance on this section, as of a date within 60 days of the cut-off date or similar date for establishing the composition of the asset pool collateralizing such asset-backed security; and

(iii) The sponsor provides, or causes to be provided, a copy of the certification described in paragraph (b)(4)(i) of this section to potential investors a reasonable period of time prior to the sale of asset-backed securities in the issuing entity, and, upon request, to the Commission and its appropriate Federal banking agency, if any.

(c) Qualified residential mortgage. The term "qualified residential mortgage" means a closed-end credit transaction to purchase or refinance a one-to-four family property at least one unit of which is the principal dwelling of a borrower that:

(1) Meets all of the criteria in paragraph (d) of this section; and

(2) Is not:

(i) Made to finance the initial construction of a dwelling;

(ii) A reverse mortgage;

(iii) A temporary or "bridge" loan with a term of twelve months or less, such as a loan to purchase a new dwelling where the borrower plans to sell a current dwelling within twelve months; or

(iv) A timeshare plan described in 11 U.S.C. § 101(53D).

(d) Eligibility criteria.

(1) First-lien required. The mortgage transaction is secured by a first lien:

(i) On the one-to-four family property to be purchased or refinanced; and

(ii) That is perfected in accordance with applicable law.

(2) Subordinate liens. If the mortgage transaction is to purchase a one-to-four family property, no other recorded or perfected liens on the one-to-four family property would exist, to the creditor's knowledge at the time of the closing of the mortgage transaction, upon the closing of that transaction.

(3) Original maturity. At the closing of the mortgage transaction, the maturity date of the mortgage transaction does not exceed 30 years.

(4) Written Application. The borrower completed and submitted to the creditor a written application for the mortgage transaction that, as supplemented or amended prior to closing, includes an acknowledgement by the borrower that the information provided in the application is true and correct as of the date executed by the borrower and that any intentional or negligent misrepresentation of the information provided in the application may result in civil liability and/or criminal penalties under 18 U.S.C. 1001.

(5) Credit history.

(i) In general. The creditor has verified and documented that within ninety (90) days prior to the closing of the mortgage transaction:

(A) The borrower is not currently 30 days or more past due, in whole or in part, on any debt obligation;

(B) Within the previous twenty-four (24) months, the borrower has not been 60 days or more past due, in whole or in part, on any debt obligation; and

(C) Within the previous thirty-six (36) months:

(1) The borrower has not been a debtor in a case commenced under Chapter 7, Chapter 12, or Chapter 13 of Title 11, United States Code, or been the subject of any Federal or State judicial judgment for the collection of any unpaid debt;

(2) The borrower has not had any personal property repossessed; and

(3) No one-to-four family property owned by the borrower has been the subject of any foreclosure, deed-in-lieu of foreclosure, or short sale.

(ii) Safe harbor. A creditor will be deemed to have met the requirements of paragraph (d)(5)(i) of this section if:

(A) The creditor, no more than 90 days before the closing of the mortgage transaction, obtains a credit report regarding the borrower from at least two consumer reporting agencies that compile and maintain files on consumers on a nationwide basis;

(B) Based on the information in such credit reports, the borrower meets all of the requirements of paragraph (d)(5)(i) of this section, and no information in a credit report subsequently obtained by the creditor before the closing of the mortgage transaction contains contrary information; and

(C) The creditor maintains copies of such credit reports in the loan file for the mortgage transaction.

(6) Payment terms. Based on the terms of the mortgage transaction at the closing of the transaction:

(i) The regularly scheduled principal and interest payments on the mortgage transaction:

(A) Would not result in an increase of the principal balance of the mortgage transaction; and

(B) Do not allow the borrower to defer payment of interest or repayment of principal;

(ii) No scheduled payment of principal and interest would be more than twice as large as any earlier scheduled payment of principal and interest;

(iii) If the rate of interest applicable to the mortgage transaction may increase after the closing of the mortgage transaction, any such increase may not exceed:

(A) 2 percent (200 basis points) in any twelve month period; and

(B) 6 percent (600 basis points) over the life of the mortgage transaction; and

(iv) The mortgage transaction does not include or provide for any prepayment penalty.

(7) Points and fees. The total points and fees payable by the borrower in connection with the mortgage transaction shall not exceed three percent of the total loan amount.

(8) Debt-to-income ratios.

(i) In general. The creditor has determined that, as of a date that is no more than 60 days prior to the closing of the mortgage transaction, the ratio of:

(A) The borrower's monthly housing debt to the borrower's monthly gross income does not exceed 28 percent; and

(B) The borrower's total monthly debt to the borrower's monthly gross income does not exceed 36 percent.

(ii) Applicable standards. For purposes of determining the borrower's compliance with the ratios set forth in paragraph (d)(8)(i) of this section, the creditor shall:

(A) Verify, document, and determine the borrower's monthly gross income in accordance with the effective income standards established in the Additional QRM Standards Appendix to this part; and

(B) Except as provided in paragraph (d)(8)(iii) of this section, verify, document, and determine the borrower's monthly housing debt and total monthly debt in accordance with the standards established in the Additional QRM Standards Appendix to this part.

(iii) Housing debt. Notwithstanding paragraph (d)(8)(ii)(B) of this section, for purposes of determining the borrower's compliance with the ratios set forth in paragraph (d)(8)(i) of this section, the creditor shall:

(A) Determine the borrower's monthly periodic payment for principal and interest on the mortgage transaction and, if the mortgage transaction is a refinancing transaction, any other credit transaction (including any open-end credit transaction as if fully drawn) that to the creditor's knowledge would exist at the closing of the refinancing transaction and that would be secured by the one-to-four family property being refinanced, based on:

(1) The maximum interest rate that is permitted or required under any feature (including any conversion or other feature that allows a variable interest rate to convert to a fixed interest rate) of the relevant credit transaction documents during the first five years after the date on which the first regular periodic payment will be due; and

(2) A payment schedule that fully amortizes the mortgage transaction over the term of the mortgage transaction; and

(B) Include in the borrower's monthly housing debt and total monthly debt the monthly pro rata amount of the following, as applicable, with respect to the one-to-four family property being purchased or refinanced:

(1) Real estate taxes;

(2) Hazard insurance, flood insurance, mortgage guarantee insurance, and any other required insurance;

(3) Homeowners' and condominium association dues;

(4) Ground rent or leasehold payments; and

(5) Special assessments.

(9) Loan-to-value ratio.

(i) Purchase mortgages. If the mortgage transaction is to purchase a one-to-four family property, at the closing of the mortgage transaction, the loan-to-value ratio of the mortgage transaction does not exceed 80 percent.

(ii) Rate and term refinancings. If the mortgage transaction is a rate and term refinancing, at the closing of the mortgage transaction, the combined loan-to-value ratio of the mortgage transaction does not exceed 75 percent.

(iii) Cash-out refinancings. If the mortgage transaction is a cash-out refinancing, at the closing of the mortgage transaction, the combined loan-to-value ratio of the mortgage transaction does not exceed 70 percent.

(10) Down payment. If the mortgage transaction is for the purchase of a one-to-four family property:

(i) The borrower provides, at closing, a cash down payment in an amount equal to at least the sum of:

(A) The closing costs payable by the borrower in connection with the mortgage transaction;

(B) 20 percent of the lesser of:

(1) The estimated market value of the one-to-four family property as determined by a qualifying appraisal; and

(2) The purchase price of the one-to-four family property to be paid in connection with the mortgage transaction; and

(C) The difference, if a positive amount, between:

(1) The purchase price of the one-to-four family property to be paid in connection with the mortgage transaction; and

(2) The estimated market value of the one-to-four family property as determined by a qualifying appraisal;

(ii) The funds used by the borrower to satisfy the down payment required by paragraph (d)(10)(i) of this section:

(A) Must come solely from borrower funds;

(B) May not be subject to any contractual obligation by the borrower to repay; and

(C) May not have been obtained by the borrower from a person or entity with an interest in the sale of the property (other than the borrower); and

(iii) The creditor shall verify and document the borrower's compliance with the conditions set forth in paragraphs (d)(10)(i) and (d)(10)(ii) of this section.

(11) Appraisal. The creditor obtained a written appraisal of the property securing the mortgage that was performed not more than 90 days prior to the closing of the mortgage transaction by an appropriately state-certified or state-licensed appraiser that conforms to generally accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice (USPAP) promulgated by the Appraisal Standards Board (ASB) of the Appraisal Foundation, the appraisal requirements of the Federal banking agencies, and applicable laws.

(12) Assumability. The mortgage transaction is not assumable by any person that was not a borrower under the mortgage transaction at closing.

(13) Default mitigation. The mortgage originator –

(i) Includes terms in the mortgage transaction documents under which the creditor commits to have servicing policies and procedures under which the creditor shall –

(A) Mitigate risk of default on the mortgage loan by taking loss mitigation actions, such as loan modification or other loss mitigation alternative, in the event the estimated resulting net present value of such action exceeds the estimated net present value of recovery through foreclosure, without regard to whether the particular action benefits the interests of a particular class of investors in a securitization;

(B) Take into account the borrower's ability to repay and other appropriate underwriting criteria in such loss mitigation actions;

(C) Initiate loss mitigation activities within 90 days after the mortgage loan becomes delinquent (if the delinquency has not been cured);

(D) Implement or maintain servicing compensation arrangements consistent with the obligations under subparagraphs (i)(A), (B), and (C);

(E) Implement procedures for addressing any whole loan owned by the creditor (or any of its affiliates) and secured by a subordinate lien on the same property that secures the first mortgage loan if the borrower becomes more than 90 days past due on the first mortgage loan;

(F) If the first mortgage loan will collateralize any asset-backed securities, disclose or require to be disclosed to potential investors within a reasonable period of time prior to the sale of the asset-backed securities a description of the procedures to be implemented pursuant to subparagraph (i)(E); and

(G) Not sell, transfer or assign servicing rights for the mortgage loan unless the agreement requires the purchaser, transferee or assignee servicer to abide by the default mitigation commitments of the creditor under this section 13(i) as if the purchaser, transferee or assignee were the creditor under this section.

(ii) Provides disclosure of the foregoing default mitigation commitments to the borrower at or prior to the closing of the mortgage transaction.

(e) Repurchase of loans subsequently determined to be non-qualified after closing. A sponsor that has relied on the exemption provided in paragraph (b) of this section with respect to a securitization transaction shall not lose such exemption with respect to such transaction if, after closing of the securitization transaction, it is determined that one or more of the residential mortgage loans collateralizing the asset-backed securities does not meet all of the criteria to be a qualified residential mortgage provided that:

(1) The depositor complied with the certification requirement set forth in paragraph (b)(4) of this section;

(2) The sponsor repurchases the loan(s) from the issuing entity at a price at least equal to the remaining aggregate unpaid principal balance and accrued interest on the loan(s) no later than 90 days after the determination that the loans do not satisfy the requirements to be a qualified residential mortgage; and

(3) The sponsor promptly notifies, or causes to be notified, the holders of the asset-backed securities issued in the securitization transaction of any loan(s) included in such securitization transaction that is (or are) required to be repurchased by the sponsor pursuant to paragraph (e)(2) of this section, including the amount of such repurchased loan(s) and the cause for such repurchase.

§ __.16 Definitions applicable to qualifying commercial mortgages, commercial loans, and auto loans.

The following definitions apply for purposes of §§ __.17 through __.20 of this part:

Appraisal Standards Board means the board of the Appraisal Foundation that establishes generally accepted standards for the appraisal profession.

Automobile loan:

(1) Means any loan to an individual to finance the purchase of, and is secured by a first lien on, a passenger car or other passenger vehicle, such as a minivan, van, sport-utility vehicle, pickup truck, or similar light truck for personal, family, or household use; and

(2) Does not include any:

(i) Loan to finance fleet sales;

(ii) Personal cash loan secured by a previously purchased automobile;

(iii) Loan to finance the purchase of a commercial vehicle or farm equipment that is not used for personal, family, or household purposes;

(iv) Lease financing; or

(v) Loan to finance the purchase of a vehicle with a salvage title.

Combined loan-to-value (CLTV) ratio means, at the time of origination, the sum of the principal balance of a first-lien mortgage loan on the property, plus the principal balance of any junior-lien mortgage loan that, to the creditor's knowledge, would exist at the closing of the transaction and that is secured by the same property, divided by:

(1) For acquisition funding, the lesser of the purchase price or the estimated market value of the real property based on an appraisal that meets the requirements set forth in §__.19(b)(2)(ii) of this part; or

(2) For refinancing, the estimated market value of the real property based on an appraisal that meets the requirements set forth in §__.19(b)(2)(ii) of this part.

Commercial loan means a secured or unsecured loan to a company or an individual for business purposes, other than any:

(1) Loan to purchase or refinance a one-to-four family residential property;

(2) Loan for the purpose of financing agricultural production; or

(3) Loan for which the primary source (fifty (50) percent or more) of repayment is expected to be derived from rents collected from persons or firms that are not affiliates of the borrower.

Commercial real estate (CRE) loan:

(1) Means a loan secured by a property with five or more single family units, or by nonfarm nonresidential real property, the primary source (fifty (50) percent or more) of repayment for which is expected to be derived from:

(i) The proceeds of the sale, refinancing, or permanent financing of the property; or

(ii) Rental income associated with the property other than rental income derived from any affiliate of the borrower; and

(2) Does not include:

(i) A land development and construction loan (including 1- to 4-family residential or commercial construction loans);

(ii) Any other land loan;

(iii) A loan to a real estate investment trusts (REITs); or

(iv) An unsecured loan to a developer.

Debt service coverage (DSC) ratio means:

(1) For qualifying leased CRE loans, qualifying multi-family loans, and other CRE loans, the ratio of:

(i) The annual NOI less the annual replacement reserve of the CRE property at the time of origination of the CRE loans; to

(ii) The sum of the borrower's annual payments for principal and interest on any debt obligation.

(2) For commercial loans, the ratio of:

(i) The borrower's EBITDA as of the most recently completed fiscal year; to

(ii) The sum of the borrower's annual payments for principal and interest on any debt obligation.

Debt to income (DTI) ratio means the ratio of:

(1) The borrower's total debt (for automobile loans), including the monthly amount due on the automobile loan; to

(2) The borrower's monthly income.

Earnings before interest, taxes, depreciation, and amortization (EBITDA) means the annual income of a business before expenses for interest, taxes, depreciation and amortization, as determined in accordance with U.S. Generally Accepted Accounting Principles (GAAP).

Environmental risk assessment means a process for determining whether a property is contaminated or exposed to any condition or substance that could result in contamination that has an adverse effect on the market value of the property or the realization of the collateral value.

First lien means a lien or encumbrance on property that has priority over all other liens or encumbrances on the property.

Junior lien means a lien or encumbrance on property that is lower in priority relative to other liens or encumbrances on the property.

Leverage ratio means the ratio of:

(1) The borrower's total debt (for commercial loans); to

(2) The borrower's EBITDA.

Machinery and equipment (M&E) collateral means collateral for a commercial loan that consists of machinery and equipment that is identifiable by make, model, and serial number.

Model year means the year determined by the manufacturer and reflected on the vehicle's Motor Vehicle Title as part of the vehicle description.

Net operating income (NOI) refers to the income a CRE property generates after all expenses have been deducted for federal income tax purposes, except for depreciation, debt service expenses, and federal and state income taxes, and excluding any unusual and nonrecurring items of income.

New vehicle means any vehicle that:

(1) Is not a used vehicle; and

(2) Has not been previously sold to an end user.

Payment-in-kind (PIK) means payments of principal or accrued interest that are not paid in cash when due, and instead are paid by increasing the principal or by providing shares or stock in the borrowing company. A PIK loan is a type of loan that typically does not provide for any cash payments of principal or interest from the borrower to the lender between the drawdown date and the maturity or refinancing date.

Purchase price means:

(1) For a new vehicle, the amount paid by the borrower for the new vehicle net of any incentive payments or manufacturer cash rebates; and

(2) For a vehicle other than a new vehicle, the lesser of:

(i) The purchase price as would be determined for a new vehicle; or

(ii) The retail value of the used vehicle, as determined by a nationally recognized automobile pricing agency and based on the manufacturer, year, model, features, and condition of the vehicle.

Qualified tenant means

(1) A tenant with a triple net lease who has satisfied all obligations with respect to the property in a timely manner; or

(2) A tenant who originally had a triple net lease that subsequently expired and currently is leasing the property on a month-to-month basis, has occupied the property for at least three years prior to the date of origination, and has satisfied all obligations with respect to the property in a timely manner.

Qualifying leased CRE loan means a CRE loan secured by commercial nonfarm real property, other than a multi-family property or a hotel, inn, or similar property:

(1) That is occupied by one or more qualified tenants pursuant to a lease agreement with a term of no less than one (1) month; and

(2) Where no more than 20 percent of the aggregate gross revenue of the property is payable from one or more tenants who:

(i) Are subject to a lease that will terminate within six months following the date of origination; or

(ii) Are not qualified tenants.

Qualifying multi-family loan:

(1) Means a CRE loan secured by any residential property (other than a hotel, motel, inn, hospital, nursing home, or other similar facility where dwellings are not leased to residents):

(i) That consists of five or more dwelling units (including apartment buildings, condominiums, cooperatives and other similar structures) primarily for residential use; and

(ii) Where at least seventy-five (75) percent of the NOI is derived from residential rents and tenant amenities (including income from parking garages, health or swim clubs, and dry cleaning), and not from other commercial uses.

Replacement reserve means the monthly capital replacement or maintenance amount based on the property type, age, construction and condition of the property that is adequate to maintain the physical condition and NOI of the property.

Salvage title means a form of vehicle title branding, which notes that the vehicle has been severely damaged and/or deemed a total loss and uneconomical to repair by an insurance company that paid a claim on the vehicle.

Total debt, with respect to a borrower, means:

(1) In the case of an automobile loan, the sum of:

(i) All monthly housing payments (rent- or mortgage-related, including property taxes, insurance and home owners association fees); and

(ii) Any of the following that are dependent upon the borrower's income for payment:

(A) Monthly payments on other debt and lease obligations, such as credit card loans or installment loans, including the monthly amount due on the automobile loan;

(B) Estimated monthly amortizing payments for any term debt, debts with other than monthly payments and debts not in repayment (such as deferred student loans, interest-only loans); and

(C) Any required monthly alimony, child support or court-ordered payments; and

(2) In the case of a commercial loan, the outstanding balance of all long-term debt (obligations that have a remaining maturity of more than one year) and the current portion of all debt that matures in one year or less.

Total liabilities ratio means the ratio of:

(1) The borrower's total liabilities, determined in accordance with U.S. GAAP; to

(2) The sum of the borrower's total liabilities and equity, less the borrower's intangible assets, with each component determined in accordance with U.S. GAAP.

Trade-in allowance means the amount a vehicle purchaser is given as a credit at the purchase of a vehicle for the fair exchange of the borrower's existing vehicle to compensate the dealer for some portion of the vehicle purchase price, except that such amount shall not exceed the trade-in value of the used vehicle, as determined by a nationally recognized automobile pricing agency and based on the manufacturer, year, model, features, and condition of the vehicle.

Triple net lease means a lease pursuant to which the lessee is required to pay rent as well as all taxes, insurance, and maintenance expenses associated with the property.

Uniform Standards of Professional Appraisal Practice (USPAP) means the standards issued by the Appraisal Standards Board for the performance of an appraisal, an appraisal review, or an appraisal consulting assignment.

Used vehicle:

(1) Means any vehicle driven more than the limited use necessary in transporting or road testing the vehicle prior to the initial sale of the vehicle; and

(2) Does not include any vehicle sold only for scrap or parts (title documents surrendered to the State and a salvage certificate issued).

§ __.17 Exceptions for qualifying commercial loans, commercial mortgages, and auto loans.

The risk retention requirements in subpart B of this part shall not apply to securitization transactions that satisfy the standards provided in §§ __.18, __.19, or __.20 of this part.

§ __.18 Underwriting standards for qualifying commercial loans.

(a) General. The securitization transaction—

(1) Is collateralized solely (excluding cash and cash equivalents) by one or more commercial loans, each of which meets all of the requirements of paragraph (b) of this section; and

(2) Does not permit reinvestment periods.

(b) Underwriting, product and other standards.

(1) Prior to origination of the commercial loan, the originator:

(i) Verified and documented the financial condition of the borrower:

(A) As of the end of the borrower's two most recently completed fiscal years; and

(B) During the period, if any, since the end of its most recently completed fiscal year;

(ii) Conducted an analysis of the borrower's ability to service its overall debt obligations during the next two years, based on reasonable projections;

(iii) Determined that, based on the previous two years' actual performance, the borrower had:

(A) A total liabilities ratio of 50 percent or less;

(B) A leverage ratio of 3.0 or less; and

(C) A DSC ratio of 1.5 or greater;

(iv) Determined that, based on the two years of projections, which include the new debt obligation, following the closing date of the loan, the borrower will have:

(A) A total liabilities ratio of 50 percent or less;

(B) A leverage ratio of 3.0 or less;

(C) A DSC ratio of 1.5 or greater; and

(v) If the loan is originated on a secured basis, obtained a first-lien security interest on all of the property pledged to collateralize the loan.

(2) The loan documentation for the commercial loan includes covenants that:

(i) Require the borrower to provide to the originator or subsequent holder, and the servicer, of the commercial loan the borrower's financial statements and supporting schedules on an ongoing basis, but not less frequently than quarterly;

(ii) Prohibit the borrower from retaining or entering into a debt arrangement that permits payments-in-kind;

(iii) Impose limits on:

(A) The creation or existence of any other security interest with respect to any of the borrower's property;

(B) The transfer of any of the borrower's assets; and

(C) Any change to the name, location or organizational structure of the borrower, or any other party that pledges collateral for the loan;

(iv) Require the borrower and any other party that pledges collateral for the loan to:

(A) Maintain insurance that protects against loss on any collateral for the commercial loan at least up to the amount of the loan, and that names the originator or any subsequent holder of the loan as an additional insured or loss payee;

(B) Pay taxes, charges, fees, and claims, where non-payment might give rise to a lien on any collateral;

(C) Take any action required to perfect or protect the security interest of the originator or any subsequent holder of the loan in the collateral for the commercial loan or the priority thereof, and to defend the collateral against claims adverse to the lender's interest;

(D) Permit the originator or any subsequent holder of the loan, and the servicer of the loan, to inspect the collateral for the commercial loan and the books and records of the borrower; and

(E) Maintain the physical condition of any collateral for the commercial loan.

(3) Loan payments required under the loan agreement are:

(i) Based on straight-line amortization of principal and interest that fully amortize the debt over a term that does not exceed five years from the date of origination; and

(ii) To be made no less frequently than quarterly over a term that does not exceed five years.

(4) The primary source of repayment for the loan is revenue from the business operations of the borrower.

(5) The loan was funded within the six (6) months prior to the closing of the securitization transaction.

(6) At the closing of the securitization transaction, all payments due on the loan are contractually current.

(7) (i) The depositor of the asset-backed security certifies that it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all assets that collateralize the asset-backed security meet all of the requirements set forth in paragraphs (b)(1) through (b)(6) of this section and has concluded that its internal supervisory controls are effective;

(ii) The evaluation of the effectiveness of the depositor's internal supervisory controls referenced in paragraph (b)(7)(i) of this section shall be performed, for each issuance of an asset-backed security, as of a date within 60 days of the cut-off date or similar date for establishing the composition of the asset pool collateralizing such asset-backed security; and

(iii) The sponsor provides, or causes to be provided, a copy of the certification described in paragraph (b)(7)(i) of this section to potential investors a reasonable period of time prior to the sale of asset-backed securities in the issuing entity, and, upon request, to its appropriate Federal banking agency, if any.

(c) Buy-back requirement. A sponsor that has relied on the exception provided in paragraph (a) of this section with respect to a securitization transaction shall not lose such exception with respect to such transaction if, after the closing of the securitization transaction, it is determined that one or more of the loans collateralizing the asset-backed securities did not meet all of the requirements set forth in paragraphs (b)(1) through (b)(6) of this section provided that:

(1) The depositor complied with the certification requirement set forth in paragraph (b)(7) of this section;

(2) The sponsor repurchases the loan(s) from the issuing entity at a price at least equal to the remaining principal balance and accrued interest on the loan(s) no later than ninety (90) days after the determination that the loans do not satisfy all of the requirements of paragraphs (b)(1) through (b)(6) of this section; and

(3) The sponsor promptly notifies, or causes to be notified, the holders of the asset-backed securities issued in the securitization transaction of any loan(s) included in such securitization transaction that is required to be repurchased by the sponsor pursuant to paragraph (c)(2) of this section, including the principal amount of such repurchased loan(s) and the cause for such repurchase.

§ __.19 Underwriting standards for qualifying CRE loans.

(a) General. The securitization transaction is collateralized solely (excluding cash and cash equivalents) by one or more CRE loans, each of which meets all of the requirements of paragraph (b) of this section.

(b) Underwriting, product and other standards.

(1) The CRE loan must be secured by a first lien on the commercial real estate.

(2) Prior to origination of the CRE loan, the originator:

(i) Verified and documented the current financial condition of the borrower;

(ii) Obtained a written appraisal of the real property securing the loan that:

(A) Was performed not more than six months from the origination date of the loan by an appropriately state-certified or state-licensed appraiser;

(B) Conforms to generally accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice (USPAP) promulgated by the Appraisal Standards Board and the appraisal requirements[239] of the Federal banking agencies; and

(C) Provides an "as is" opinion of the market value of the real property, which includes an income valuation approach that uses a discounted cash flow analysis;

(iii) Qualified the borrower for the CRE loan based on a monthly payment amount derived from a straight-line amortization of principal and interest over the term of the loan (but not exceeding 20 years);

(iv) Conducted an environmental risk assessment to gain environmental information about the property securing the loan and took appropriate steps to mitigate any environmental liability determined to exist based on this assessment;

(v) Conducted an analysis of the borrower's ability to service its overall debt obligations during the next two years, based on reasonable projections;

(vi) Determined that, based on the previous two years' actual performance, the borrower had:

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[239] OCC: 12 CFR part 34, subpart C; FRB: 12 CFR part 208, subpart E, and 12 CFR part 225, subpart G; and FDIC: 12 CFR part 323.

(A) A DSC ratio of 1.5 or greater, if the loan is a qualifying leased CRE loan, net of any income derived from a tenant(s) who is not a qualified tenant(s);

(B) A DSC ratio of 1.5 or greater, if the loan is a qualifying multi-family property loan; or

(C) A DSC ratio of 1.7 or greater, if the loan is any other type of CRE loan;

(vii) Determined that, based on two years of projections, which include the new debt obligation, following the origination date of the loan, the borrower will have:

(A) A DSC ratio of 1.5 or greater, if the loan is a qualifying leased CRE loan, net of any income derived from a tenant(s) who is not a qualified tenant(s);

(B) A DSC ratio of 1.5 or greater, if the loan is a qualifying multi-family property loan; or

(C) A DSC ratio of 1.7 or greater, if the loan is any other type of CRE loan.

(3) The loan documentation for the CRE loan includes covenants that:

(i) Require the borrower to provide to the originator and any subsequent holder of the commercial loan, and the servicer, the borrower's financial statements and supporting schedules on an ongoing basis, but not less frequently than quarterly, including information on existing, maturing and new leasing or rent-roll activity for the property securing the loan, as appropriate; and

(ii) Impose prohibitions on:

(A) The creation or existence of any other security interest with respect to any collateral for the CRE loan;

(B) The transfer of any collateral pledged to support the CRE loan; and

(C) Any change to the name, location or organizational structure of the borrower, or any other party that pledges collateral for the loan;

(iii) Require the borrower and any other party that pledges collateral for the loan to:

(A) Maintain insurance that protects against loss on any collateral for the CRE loan, at least up to the amount of the loan, and names the originator or any subsequent holder of the loan as an additional insured or loss payee;

(B) Pay taxes, charges, fees, and claims, where non-payment might give rise to a lien on any collateral for the CRE loan;

(C) Take any action required to perfect or protect the security interest of the originator or any subsequent holder of the loan in the collateral for the CRE loan or the priority thereof, and to defend such collateral against claims adverse to the originator's or subsequent holder's interest;

(D) Permit the originator or any subsequent holder of the loan, and the servicer, to inspect the collateral for the CRE loan and the books and records of the borrower or other party relating to the collateral for the CRE loan;

(E) Maintain the physical condition of the collateral for the CRE loan;

(F) Comply with all environmental, zoning, building code, licensing and other laws, regulations, agreements, covenants, use restrictions, and proffers applicable to the collateral;

(G) Comply with leases, franchise agreements, condominium declarations, and other documents and agreements relating to the operation of the collateral, and to not modify any material terms and conditions of such agreements over the term of the loan without the consent of the originator or any subsequent holder of the loan, or the servicer; and

(H) Not materially alter the collateral for the CRE loan without the consent of the originator or any subsequent holder of the loan, or the servicer.

(4) The loan documentation for the CRE loan prohibits the borrower from obtaining a loan secured by a junior lien on any property that serves as collateral for the CRE loan, unless such loan finances the purchase of machinery and equipment and the borrower pledges such machinery and equipment as additional collateral for the CRE loan.

(5) The CLTV ratio for the loan is:

(i) Less than or equal to 65 percent; or

(ii) Less than or equal to 60 percent, if the capitalization rate used in an appraisal that meets the requirements set forth in paragraph (b)(2)(ii) of this section is less than or equal to the sum of:

(A) The 10-year swap rate, as reported in the Federal Reserve Board H.15 Report as of the date concurrent with the effective date of an appraisal that meets the requirements set forth in paragraph (b)(2)(ii) of this section; and

(B) 300 basis points.

(6) All loan payments required to be made under the loan agreement are:

(i) Based on straight-line amortization of principal and interest over a term that does not exceed 20 years; and

(ii) To be made no less frequently than monthly over a term of at least ten years.

(7) Under the terms of the loan agreement:

(i) Any maturity of the note occurs no earlier than ten years following the date of origination;

(ii) The borrower is not permitted to defer repayment of principal or payment of interest; and

(iii) The interest rate on the loan is:

(A) A fixed interest rate; or

(B) An adjustable interest rate and the borrower, prior to or concurrently with origination of the CRE loan, obtained a derivative that effectively results in a fixed interest rate.

(8) The originator does not establish an interest reserve at origination to fund all or part of a payment on the loan.

(9) At the closing of the securitization transaction, all payments due on the loan are contractually current.

(10) (i) The depositor of the asset-backed security certifies that it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all assets that collateralize the asset-backed security meet all of the requirements set forth in paragraphs (b)(1) through (9) of this section and has concluded that its internal supervisory controls are effective;

(ii) The evaluation of the effectiveness of the depositor's internal supervisory controls referenced in paragraph (b)(10)(i) of this section shall be performed, for each issuance of an asset-backed security, as of a date within 60 days of the cut-off date or similar date for establishing the composition of the asset pool collateralizing such asset-backed security; and

(iii) The sponsor provides, or causes to be provided, a copy of the certification described in paragraph (b)(10)(i) of this section to potential investors a reasonable period of time prior to the sale of asset-backed securities in the issuing entity, and, upon request, to its appropriate Federal banking agency, if any.

(c) Buy-back requirement. A sponsor that has relied on the exception provided in paragraph (a) of this section with respect to a securitization transaction shall not lose such exception with respect to such transaction if, after the closing of the securitization transaction, it is determined that one or more of the CRE loans collateralizing the asset-backed securities did not meet all of the requirements set forth in paragraphs (b)(1) through (b)(9) of this section provided that:

(1) The depositor has complied with the certification requirement set forth in paragraph (b)(10) of this section;

(2) The sponsor repurchases the loan(s) from the issuing entity at a price at least equal to the remaining principal balance and accrued interest on the loan(s) no later than ninety (90) days after the determination that the loans do not satisfy all of the requirements of paragraphs (b)(1) through (b)(9) of this section; and

(3) The sponsor promptly notifies, or causes to be notified, the holders of the asset-backed securities issued in the securitization transaction of any loan(s) included in such securitization transaction that is required to be repurchased by the sponsor pursuant to paragraph (c)(2) of this section, including the principal amount of such repurchased loan(s) and the cause for such repurchase.

§ __.20 Underwriting standards for qualifying auto loans.

(a) General. The securitization transaction is collateralized solely (excluding cash and cash equivalents) by one or more automobile loans, each of which meets all of the requirements of paragraph (b) of this section.

(b) Underwriting, product and other standards.

(1) Prior to origination of the automobile loan, the originator:

(i) Verified and documented that within 30 days of the date of origination:

(A) The borrower was not currently 30 days or more past due, in whole or in part, on any debt obligation;

(B) Within the previous twenty-four (24) months, the borrower has not been 60 days or more past due, in whole or in part, on any debt obligation;

(C) Within the previous thirty-six (36) months, the borrower has not:

(1) Been a debtor in a proceeding commenced under Chapter 7 (Liquidation), Chapter 11 (Reorganization), Chapter 12 (Family Farmer or Family Fisherman plan), or Chapter 13 (Individual Debt Adjustment) of the U.S. Bankruptcy Code; or

(2) Been the subject of any Federal or State judicial judgment for the collection of any unpaid debt;

(D) Within the previous thirty-six (36) months, no one-to-four family property owned by the borrower has been the subject of any foreclosure, deed in lieu of foreclosure, or short sale; or

(E) Within the previous thirty-six (36) months, the borrower has not had any personal property repossessed;

(ii) Determined and documented that, upon the origination of the loan, the borrower's DTI ratio is less than or equal to thirty-six (36) percent.

(A) For the purpose of making the determination under paragraph (b)(1)(ii) of this section, the originator must:

(1) Verify and document all income of the borrower that the originator includes in the borrower's effective monthly income (using payroll stubs, tax returns, profit and loss statements, or other similar documentation); and

(2) On or after the date of the borrower's written application and prior to origination, obtain a credit report regarding the borrower from a consumer reporting agency that compiles and maintain files on consumers on a nationwide basis (within the meaning of 15 U.S.C. 1681a(p)) and verify that all outstanding debts reported in the borrower's credit report are incorporated into the calculation of the borrower's DTI ratio under paragraph (b)(1)(ii) of this section;

(2) An originator will be deemed to have met the requirements of paragraph (b)(1)(i) of this section if:

(i) The originator, no more than 90 days before the closing of the loan, obtains a credit report regarding the borrower from at least two consumer reporting agencies that compile and maintain files on consumers on a nationwide basis (within the meaning of 15 U.S.C. 1681a(p));

(ii) Based on the information in such credit reports, the borrower meets all of the requirements of paragraph (b)(1)(i) of this section, and no information in a credit report subsequently obtained by the originator before the closing of the mortgage transaction contains contrary information; and

(iii) The originator obtains electronic or hard copies of such credit reports.

(3) At closing of the automobile loan, the borrower makes a down payment from the borrower's personal funds and trade-in allowance, if any, that is at least equal to the sum of:

(i) The full cost of the vehicle title, tax, and registration fees;

(ii) Any dealer-imposed fees; and

(iii) 20 percent of the vehicle purchase price.

(4) The transaction documents require the originator, subsequent holder of the loan, or an agent of the originator or subsequent holder of the loan to maintain physical possession of the title for the vehicle until the loan is repaid in full and the borrower has otherwise satisfied all obligations under the terms of the loan agreement.

(5) If the loan is for a new vehicle, the terms of the loan agreement provide a maturity date for the loan that does not exceed 5 years from the date of origination.

(6) If the loan is for a vehicle other than a new vehicle, the term of the loan (as set forth in the loan agreement) plus the difference between the current model year and the vehicle's model year does not exceed 5 years.

(7) The terms of the loan agreement:

(i) Specify a fixed rate of interest for the life of the loan;

(ii) Provide for a monthly payment amount that:

(A) Is based on straight-line amortization of principal and interest over the term of the loan; and

(B) Do not permit the borrower to defer repayment of principal or payment of interest; and

(C) Require the borrower to make the first payment on the automobile loan within 45 days of the date of origination.

(8) At the closing of the securitization transaction, all payments due on the loan are contractually current; and

(9) (i) The depositor of the asset-backed security certifies that it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all assets that collateralize the asset-backed security meet all of the requirements set forth in paragraphs (b)(1) through (b)(8) of this section and has concluded that its internal supervisory controls are effective;

(ii) The evaluation of the effectiveness of the depositor's internal supervisory controls referenced in paragraph (b)(9)(i) of this section shall be performed, for each issuance of an asset-backed security, as of a date within 60 days of the cut-off date or similar date for establishing the composition of the asset pool collateralizing such asset-backed security; and

(iii) The sponsor provides, or causes to be provided, a copy of the certification described in paragraph (b)(9)(i) of this section to potential investors a reasonable period of time prior to the sale of asset-backed securities in the issuing entity, and, upon request, to its appropriate Federal banking agency, if any.

(c) Buy-back requirement. A sponsor that has relied on the exception provided in this paragraph (a) of this section with respect to a securitization transaction shall not lose such exception with respect to such transaction if, after the closing of the securitization transaction, it is determined that one or more of the automobile loans collateralizing the asset-backed securities did not meet all of the requirements set forth in paragraphs (b)(1) through (b)(8) of this section provided that:

(1) The depositor has complied with the certification requirement set forth in paragraph (b)(9) of this section;

(2) The sponsor repurchases the loan(s) from the issuing entity at a price at least equal to the remaining principal balance and accrued interest on the loan(s) no later than 90 days after the determination that the loans do not satisfy all of the requirements of paragraphs (b)(1) through (b)(8) of this section; and

(3) The sponsor promptly notifies, or causes to be notified, the holders of the asset-backed securities issued in the securitization transaction of any loan(s) included in such securitization transaction that is required to be repurchased by the sponsor pursuant to paragraph (c)(2) of this section, including the principal amount of such repurchased loan(s) and the cause for such repurchase.

§ __.21 General exemptions.

(a) This part shall not apply to:

(1) Any securitization transaction that:

(i) Is collateralized solely (excluding cash and cash equivalents) by residential, multifamily, or health care facility mortgage loan assets that are insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United States; or

(ii) Involves the issuance of asset-backed securities that:

(A) Are insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United States; and

(B) Are collateralized solely (excluding cash and cash equivalents) by residential, multifamily, or health care facility mortgage loan assets or interests in such assets.

(2) Any securitization transaction that is collateralized solely (excluding cash and cash equivalents) by loans or other assets made, insured, guaranteed, or purchased by any institution that is subject to the supervision of the Farm Credit Administration, including the Federal Agricultural Mortgage Corporation;

(3) Any asset-backed security that is a security issued or guaranteed by any State of the United States, or by any political subdivision of a State or territory, or by any public instrumentality of a State or territory that is exempt from the registration requirements of the Securities Act of 1933 by reason of section 3(a)(2) of that Act (15 U.S.C. 77c(a)(2)); and

(4) Any asset-backed security that meets the definition of a qualified scholarship funding bond, as set forth in section 150(d)(2) of the Internal Revenue Code of 1986 (26 U.S.C. 150(d)(2)).

(5) Any securitization transaction that:

(i) Is collateralized solely (other than cash and cash equivalents) by existing asset-backed securities issued in a securitization transaction:

(A) For which credit risk was retained as required under subpart B of this part; or

(B) That was exempted from the credit risk retention requirements of this part pursuant to subpart D of this part;

(ii) Is structured so that it involves the issuance of only a single class of ABS interests; and

(iii) Provides for the pass-through of all principal and interest payments received on the underlying ABS (net of expenses of the issuing entity) to the holders of such class.

(b) This part shall not apply to any securitization transaction if the asset-backed securities issued in the transaction are:

(1) Collateralized solely (excluding cash and cash equivalents) by obligations issued by the United States or an agency of the United States;

(2) Collateralized solely (excluding cash and cash equivalents) by assets that are fully insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United States (other than those referred to in paragraph (a)(1)(i) of this section); or

(3) Fully guaranteed as to the timely payment of principal and interest by the United States or any agency of the United States;

(c) Rule of construction. Securitization transactions involving the issuance of asset-backed securities that are either issued, insured, or guaranteed by, or are collateralized by obligations issued by, or loans that are issued, insured, or guaranteed by, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, or a Federal home loan bank shall not on that basis qualify for exemption under this section.

§ __.22 Safe harbor for certain foreign-related transactions.

(a) In general. This part shall not apply to a securitization transaction if all the following conditions are met:

(1) The securitization transaction is not required to be and is not registered under the Securities Act of 1933 (15 U.S.C. 77a et seq.);

(2) No more than 10 percent of the dollar value by proceeds (or equivalent if sold in a foreign currency) of all classes of ABS interests sold in the securitization transaction are sold to U.S. persons or for the account or benefit of U.S. persons;

(3) Neither the sponsor of the securitization transaction nor the issuing entity is:

(i) Chartered, incorporated, or organized under the laws of the United States, any State of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other possession of the United States (each of the foregoing, a "U.S. jurisdiction");

(ii) An unincorporated branch or office (wherever located) of an entity chartered, incorporated, or organized under the laws of a U.S. jurisdiction; or

(iii) An unincorporated branch or office located in a U.S. jurisdiction of an entity that is chartered, incorporated, or organized under the laws of a jurisdiction other than a U.S. jurisdiction; and

(4) If the sponsor or issuing entity is chartered, incorporated, or organized under the laws of a jurisdiction other than a U.S. jurisdiction, no more than 25 percent (as determined based on unpaid principal balance) of the assets that collateralize the ABS interests sold in the securitization transaction were acquired by the sponsor or issuing entity, directly or indirectly, from:

(i) A consolidated affiliate of the sponsor or issuing entity that is chartered, incorporated, or organized under the laws of a U.S. jurisdiction; or

(ii) An unincorporated branch or office of the sponsor or issuing entity that is located in a U.S. jurisdiction.

(b) Evasions prohibited. In view of the objective of these rules and the policies underlying Section 15G of the Exchange Act, the safe harbor described in paragraph (a) of this section is not available with respect to any transaction or series of transactions that, although in technical compliance with such paragraph (a), is part of a plan or scheme to evade the requirements of section 15G and this Regulation. In such cases, compliance with section 15G and this part is required.

§ __.23 Additional exemptions.

(a) Securitization transactions. The federal agencies with rulewriting authority under section 15G(b) of the Exchange Act (15 U.S.C. 78o-11(b)) with respect to the type of assets involved may jointly provide a total or partial exemption of any securitization transaction as such agencies determine may be appropriate in the public interest and for the protection of investors.

(b) Exceptions, exemptions, and adjustments. The Federal banking agencies and the Commission, in consultation with the Federal Housing Finance Agency and the Department of Housing and Urban Development, may jointly adopt or issue exemptions, exceptions or adjustments to the requirements of this part, including exemptions, exceptions or adjustments for classes of institutions or assets in accordance with section 15G(e) of the Exchange Act (15 U.S.C. 78o-11(e)).

Additional QRM Standards Appendix

Standards for Determining Acceptable Sources of Borrower Funds, Borrower's Monthly Gross Income, Monthly Housing Debt, and Total Monthly Debt

I. Borrower Funds to Close

A. Cash and Savings/Checking Accounts as Acceptable Sources of Funds

1. Earnest Money Deposit

The lender must verify with documentation, the deposit amount and source of funds, if the amount of the earnest money deposit:

- Exceeds 2 percent of the sales price, or
- Appears excessive based on the borrower's history of accumulating savings.

Satisfactory documentation includes:

- A copy of the borrower's cancelled check
- Certification from the deposit-holder acknowledging receipt of funds, or
- Separate evidence of the source of funds.

Separate evidence includes a verification of deposit (VOD) or bank statement showing that the average balance was sufficient to cover the amount of the earnest money deposit, at the time of the deposit.

2. Savings and Checking Accounts

A VOD, along with the most recent bank statement, may be used to verify savings and checking accounts.

If there is a large increase in an account, or the account was recently opened, the lender must obtain from the borrower a credible explanation of the source of the funds.

3. Cash Saved at Home

Borrowers who have saved cash at home and are able to adequately demonstrate the ability to do so, are permitted to have this money included as an acceptable source of funds to close the mortgage.

To include cash saved at home when assessing the borrower's cash assets, the:

- Money must be verified, whether deposited in a financial institution, or held by the escrow/title company, and

- Borrower must provide satisfactory evidence of the ability to accumulate such savings.

4. Verifying Cash Saved at Home

Verifying the cash saved at home assets requires the borrower to explain in writing:

- How the funds were accumulated, and
- The amount of time it took to accumulate the funds.

The lender must determine the reasonableness of the accumulation, based on the:

- Borrower's income stream
- Time period during which the funds were saved
- Borrower's spending habits, and
- Documented expenses and the borrower's history of using financial institutions.

Note: Borrowers with checking and/or savings accounts are less likely to save money at home, than individuals with no history of such accounts.

5. Cash Accumulated with Private Savings Clubs

Some borrowers may choose to use non-traditional methods to save money by making deposits into private savings clubs. Often, these private savings clubs pool resources for use among the membership.

If a borrower claims that the cash to close mortgage is from savings held with a private savings club, he/she *must* be able to adequately document the accumulation of the funds with the club.

6. Requirements for Private Savings Clubs

While private savings clubs are not supervised banking institutions, the clubs must, at a minimum, have:

- Account ledgers
- Receipts from the club
- Verification from the club treasurer, and
- Identification of the club.

The lender must reverify the information, and the underwriter must be able to determine that:

- It was reasonable for the borrower to have saved the money claimed, and
- There is no evidence that the funds were borrowed with an expectation of repayment.

B. Investments as an Acceptable Source of Funds

1. IRAs, Thrift Savings Plans, and 401(k)s and Keogh Accounts

Up to 60 percent of the value of assets such as IRAs, thrift savings plans, 401(k) and Keogh accounts may be included in the underwriting analysis, unless the borrower provides conclusive evidence that a higher percentage may be withdrawn, after subtracting any:

- Federal income tax, and
- Withdrawal penalties.

Notes:

- Redemption evidence is required.
- The portion of the assets not used to meet closing requirements, after adjusting for taxes and penalties may be counted as reserves.

2. Stocks and Bonds

The monthly or quarterly statement provided by the stockbroker or financial institution managing the portfolio may be used to verify the value of stocks and bonds.

Note: The actual receipt of funds must be verified and documented.

3. Savings Bonds

Government issued bonds are counted at the original purchase price, unless eligibility for redemption and the redemption value are confirmed.

Note: The actual receipt of funds at redemption must be verified.

C. Gifts as an Acceptable Source of Funds

1. Description of Gift Funds

In order for funds to be considered a gift there must be no expected or implied repayment of the funds to the donor by the borrower.

Note: The portion of the gift not used to meet closing requirements may be counted as reserves.

2. Who Can Provide a Gift?

An outright gift of the cash investment is acceptable if the donor is:

- The borrower's relative
- The borrower's employer or labor union
- A charitable organization
- A governmental agency or public entity that has a program providing home ownership assistance to
    - Low- and moderate-income families
    - First-time homebuyers, or

- A close friend with a clearly defined and documented interest in the borrower.

3. Who Cannot Provide a Gift?

The gift donor may *not* be a person or entity with an interest in the sale of the property, such as:

- The seller
- The real estate agent or broker
- The builder, or
- An associated entity.

Gifts from these sources are considered inducements to purchase, and *must* be subtracted from the sales price.

Note: This applies to properties where the seller is a government agency selling foreclosed properties, such as the US Department of Veterans Affairs (VA) or Rural Housing Services.

4. Lender Responsibility for Verifying the Acceptability of Gift Fund Sources

Regardless of when gift funds are made available to a borrower, the lender *must* be able to determine that the gift funds were *not* provided by an unacceptable source, and were the donor's own funds.

When the transfer occurs at closing, the lender is responsible for verifying that the closing agent received the funds from the donor for the amount of the gift, and that the funds were from an acceptable source.

5. Requirements Regarding Donor Source of Funds

As a general rule, how a donor obtains gift funds is not of concern, provided that the funds are not derived in any manner from a party to the sales transaction.

Donors may borrow gift funds from any other acceptable source, provided the mortgage borrowers are not obligors to any note to secure money borrowed to give the gift.

6. Equity Credit

Only family members may provide equity credit as a gift on property being sold to other family members.

7. Payment of Consumer Debt Must Result in Sales Price Reduction

The payment of consumer debt by third parties is considered to be an inducement to purchase.

While sellers and other parties may make contributions subject to any percentage limitation of the sales price of a property toward a buyer's actual closing costs and financing concessions, this applies *exclusively* to the mortgage financing provision.

When someone other than a family member has paid off debts or other expenses on behalf of the borrower:

- The funds must be treated as an inducement to purchase, and
- There *must* be a dollar for dollar reduction to the sales price when calculating the maximum insurable mortgage.

Note: The dollar for dollar reduction to the sales price also applies to gift funds not meeting the requirement that:

- The gift be for down payment assistance, and
- That it be provided by an acceptable source.

8. Using Downpayment Assistance Programs

Downpayment assistance programs providing gifts administered by charitable organizations, such as nonprofits should be carefully monitored. Nonprofit entities should not provide gifts to pay off:

- Installment loans
- Credit cards
- Collections
- Judgments, and
- Similar debts.

Lenders *must* ensure that a gift provided by a charitable organization meets these requirements and that the transfer of funds is properly documented.

9. Gifts from Charitable Organizations that Lose or Give Up Their Federal Tax-Exempt Status.

If a charitable organization makes a gift that is to be used for all, or part, of a borrower's down payment, and the organization providing the gift loses or gives up its Federal tax exempt status, the gift will be recognized as an acceptable source of the down payment provided that:

- The gift is made to the borrower
- The gift is properly documented, and
- The borrower has entered into a contract of sale (including any amendments to purchase price) *on, or before*, the date the IRS officially announces that the charitable organization's tax exempt status is terminated.

10. Lender Responsibility for Ensuring That an Entity Is a Charitable Organization

The lender is responsible for ensuring that an entity is a charitable organization as defined by Section 501(a) of the Internal Revenue Code (IRC) of 1986 (26 U.S.C. 150(d)(2)) pursuant to Section 501(c) (3) of the IRC.

One resource available to lenders for obtaining this information is the Internal Revenue Service (IRS) Publication 78, *Cumulative List of Organizations described in Section 170(c) of the Internal Revenue Code of 1986*, which contains a list of organizations eligible to receive tax-deductible charitable contributions.

The IRS has an online version of this list that can help lenders and others conduct a search of these organizations. The online version can be found at http://apps.irs.gov/app/pub78 using the following instructions to obtain the latest update:

- Enter search data and click "Search"
- Click "Search for Charities" under the "Charities & Non-Profits Topics" heading on the left-hand side of the page
- Click "Recent Revocations and Deletions from Cumulative List" under the "Additional Information" heading in the middle of the page, and
- Click the name of the organization if the name appears on the list displayed.

D. Gift Fund Required Documentation

1. Gift Letter Requirement

A lender must document any borrower gift funds through a gift letter, signed by the donor and borrower. The gift letter must show the donor's name, address, telephone number, specify the dollar amount of the gift, and state the nature of the donor's relationship to the borrower and that no repayment is required. If sufficient funds required for closing are not already verified in the borrower's accounts, document the transfer of the gift funds to the borrower's accounts, in accordance with the instructions described in section (I)(D)(2).

2. Documenting the Transfer of Gift Funds

The lender must document the transfer of the gift funds from the donor to the borrower. The table below describes the requirements for the transfer of gift funds.

If the gift funds ...	Then ...
Are in the borrower's account	Obtain • A copy of the withdrawal document showing that the withdrawal is from the donor's account, and • The borrower's deposit slip and bank statement showing the deposit.
• Are to be provided at closing, and • Are in the form of a certified check from the donor's account	Obtain a • Bank statement showing the withdrawal from the donor's account, and • Copy of the certified check.
• Are to be provided at closing, and • Are in the form of a cashier's check, money order, official check, or other type of bank check	Have the donor provide a withdrawal document or cancelled check for the amount of the gift, showing that the funds came from the donor's personal account.
• Are to be provided at closing, and • Are in the form of an electronic wire transfer to the closing agent	Have the donor provide documentation of the wire transfer. **Note**: The lender must obtain and keep the documentation of the wire transfer in its mortgage loan application binder. While the document does not need to be provided in the insurance binder, it must be available for inspection.
• Are being borrowed by the donor, and	Have the donor provide written evidence that the funds were borrowed from an acceptable source, not

If the gift funds ...	Then ...
• Documentation from the bank or other savings account is *not* available	from a party to the transaction, including the lender. ***IMPORTANT***: *Cash on hand* is *not* an acceptable source of donor gift funds.

E. Property Related Acceptable Sources of Funds

1. Type of Personal Property

In order to obtain cash for closing, a borrower may sell various personal property items. The types of personal property items that a borrower can sell include

- Cars
- Recreational vehicles
- Stamps
- Coins, and
- Baseball card collections.

2. Sale of Personal Property Documentation Requirement

If a borrower plans to sell personal property items to obtain funds for closing, he/she must provide

- Satisfactory estimate of the worth of the personal property items, and
- Evidence that the items were sold.

The estimated worth of the items being sold may be in the form of

- Published value estimates issued by organizations, such as

- automobile dealers, or
- philatelic or numismatic associations, or

- A separate written appraisal by a qualified appraiser with no financial interest in the loan transaction.

Only the *lesser* of the estimated value or actual sales prices are considered as assets to close.

3. Net Sales Proceeds From a Property

The net proceeds from an arms-length sale of a currently owned property may be used for the cash investment on a new house. The borrower must provide satisfactory evidence of the accrued cash sales proceeds.

If the property has not sold by the time of underwriting, condition loan approval by verifying the actual proceeds received by the borrower. The lender must document the

- Actual sale, and
- Sufficiency of the net proceeds required for settlement.

Note: If the property has not sold by the time of the subject settlement, the existing mortgage must be included as a liability for qualifying purposes.

4. Commission From the Sale of the Property

If the borrower is a licensed real estate agent entitled to a real estate commission from the sale of the property being purchased, then he/she may use that amount for the cash investment, with no adjustment to the maximum mortgage required.

A family member entitled to the commission may also provide gift funds to the borrower.

5. Trade Equity

The borrower may agree to trade his/her real property to the seller as part of the cash investment. The amount of the borrower's equity contribution is determined by

- Using the *lesser* of the property's appraised value or sales price, and
- Subtracting all liens against the property being traded, along with any real estate commission.

In order to establish the property value, the borrower must provide

- A residential appraisal no more than six months old to determine the property's value, and
- Evidence of ownership.

Note: If the property being traded has an FHA-insured mortgage, assumption processing requirements and restrictions apply.

6. Rent Credit

The cumulative amount of rental payments that exceed the appraiser's estimate of fair market rent may be considered accumulation of the borrower's cash investment.

The following *must* be included in the endorsement package:

- Rent with option to purchase agreement, and
- Appraiser's estimate of market rent.

Conversely, treat the rent as an inducement to purchase with an appropriate reduction to the mortgage, *if* the sales agreement reveals that the borrower

- Has been living in the property rent-free, or
- Has an agreement to occupy the property as a rental considerably below fair market value in anticipation of eventual purchase.

Exception: An exception may be granted when a builder

- Fails to deliver a property at an agreed to time, and
- Permits the borrower to occupy an existing or other unit for less than market rent until construction is complete.

7. Sweat Equity Considered a Cash Equivalent

Labor performed, or materials furnished by the borrower before closing on the property being purchased (known as "sweat equity"), may be considered the equivalent of a cash investment, to the amount of the estimated cost of the work or materials.

Note: Sweat equity may also be "gifted," subject to

- The additional requirements in section (I)(E)(8), and
- The gift fund requirements described in section (I)(D).

8. Additional Sweat Equity Requirements

The table below describes additional requirements for applying sweat equity as a cash equivalent and as an acceptable source of borrower funds.

Sweat Equity Category	**Requirement**
Existing Construction	Only repairs or improvements listed on the

	appraisal are eligible for sweat equity. Any work completed or materials provided before the appraisal are *not* eligible.
Proposed Construction	The sales contract must indicate the tasks to be performed by the borrower during construction.
Borrower's Labor	The borrower must demonstrate his/her ability to complete the work in a satisfactory manner. The lender must document the contributory value of the labor either through • The appraiser's estimate, or • A cost-estimating service.
Delayed Work	The following *cannot* be included as sweat equity: • Delayed work (on-site escrow) • Clean up • Debris removal, and • Other general maintenance.
Cash Back	Cash back to the borrower in sweat equity transactions is *not* permitted.
Sweat Equity on Property Not Being Purchased	Sweat equity is *not* acceptable on property other than the property being purchased. Compensation for work performed on other properties must be • In cash, and • Properly documented.
Source of Funds Evidence	Evidence of the following must be provided if the borrower furnishes funds and materials: • Source of the funds, and

	• Market value of the materials.

9. Trade-In Manufactured Home

An acceptable source of borrower cash investment commonly associated with manufactured homes is the sale or trade-in of another manufactured home that is not considered real estate. Trade-ins for cash funds are considered a seller inducement and are not permitted.]

II. Borrower Eligibility

A. Stability of Income

1. Effective Income

Income may not be used in calculating the borrower's income ratios if it comes from any source that cannot be verified, is not stable, or will not continue.

2. Verifying Employment History

The lender must verify the borrower's employment for the most recent two full years, and the borrower must

- Explain any gaps in employment that span one or more months, and
- Indicate if he/she was in school or the military for the recent two full years, providing Evidence supporting this claim, such as
  - College transcripts, or
  - Discharge papers.

Allowances can be made for seasonal employment, typical for the building trades and agriculture, if documented by the lender.

Note: A borrower with a 25 percent or greater ownership interest in a business is considered self employed and will be evaluated as a self employed borrower for underwriting purposes.

3. Analyzing a Borrower's Employment Record

When analyzing the probability of continued employment, lenders must examine:

- The borrower's past employment record
- Qualifications for the position
- Previous training and education, and
- The employer's confirmation of continued employment.

Favorably consider a borrower for a mortgage if he/she changes jobs frequently within the same line of work, but continues to advance in income or benefits. In this analysis, income stability takes precedence over job stability.

4. Borrowers Returning to Work after an Extended Absence

A borrower's income may be considered effective and stable when recently returning to work after an extended absence if he/she:

- Is employed in the current job for six months or longer, and
- Can document a two year work history prior to an absence from employment using
    - Traditional employment verifications, and/or
    - Copies of W-2 forms or pay stubs.

Note: An acceptable employment situation includes individuals who took several years off from employment to raise children, then returned to the workforce.

Important: Situations not meeting the criteria listed above may *only* be considered as compensating factors. Extended absence is defined as six months.

B. Salary, Wage and Other Forms of Income

1. General Policy on Borrower Income Analysis

The income of each borrower who will be obligated for the mortgage debt *must* be analyzed to determine whether his/her income level can be reasonably expected to continue through at least the first three years of the mortgage loan.

In most cases, a borrower's income is limited to salaries or wages. Income from other sources can be considered as effective, when properly verified and documented by the lender.

Notes:

- Effective income for borrowers planning to retire during the first three-year period *must* include the amount of:
    - Documented retirement benefits
    - Social Security payments, or
    - Other payments expected to be received in retirement.
- Lenders *must not* ask the borrower about possible, future maternity leave.

2. Overtime and Bonus Income

Overtime and bonus income can be used to qualify the borrower if he/she has received this income for the past two years, and it will likely continue. If the employment verification states that the overtime and bonus income is unlikely to continue, it may not be used in qualifying.

The lender must develop an average of bonus or overtime income for the past two years. Periods of overtime and bonus income less than two years may be acceptable, provided the lender can justify and document in writing the reason for using the income for qualifying purposes.

3. Establishing an Overtime and Bonus Income Earning Trend

The lender *must* establish and document an earnings trend for overtime and bonus income. If either type of income shows a continual decline, the lender *must* document in writing a sound rationalization for including the income when qualifying the borrower.

A period of more than two years must be used in calculating the average overtime and bonus income if the income varies significantly from year to year.

4. Qualifying Part- Time Income

Part-time and seasonal income can be used to qualify the borrower if the lender documents that the borrower has worked the part-time job uninterrupted for the past two years, and plans to continue. Many low and moderate income families rely on part-time and seasonal income for day to day needs, and lenders should not restrict consideration of such income when qualifying these borrowers.

Part-time income received for less than two years may be included as effective income, provided that the lender justifies and documents that the income is likely to continue.

Part-time income not meeting the qualifying requirements may be considered as a compensating factor only.

Note: For qualifying purposes, "part-time" income refers to employment taken to supplement the borrower's income from regular employment; part-time employment is not a primary job and it is worked less than 40 hours.

5. Income from Seasonal Employment

Seasonal income is considered uninterrupted, and may be used to qualify the borrower, if the lender documents that the borrower:

- Has worked the same job for the past two years, and
- Expects to be rehired the next season.

Seasonal employment includes:

- Umpiring baseball games in the summer, or
- Working at a department store during the holiday shopping season.

6. Primary Employment Less Than 40 Hour Work Week

When a borrower's primary employment is less than a typical 40-hour work week, the lender should evaluate the stability of that income as regular, on-going primary employment.

Example: A registered nurse may have worked 24 hours per week for the last year. Although this job is less than the 40-hour work week, it is the borrower's primary employment, and should be considered effective income.

7. Commission Income

Commission income *must* be averaged over the previous two years. To qualify commission income, the borrower must provide:

- Copies of signed tax returns for the last two years, and
- The most recent pay stub.

Commission income showing a decrease from one year to the next requires significant compensating factors before a borrower can be approved for the loan.

Borrowers whose commission income was received for more than one year, but less than two years may be considered favorably if the underwriter can:

- Document the likelihood that the income will continue, and
- Soundly rationalize accepting the commission income.

Notes:

- Unreimbursed business expenses must be subtracted from gross income.
- A commissioned borrower is one who receives more than 25 percent of his/her annual income from commissions.
- A tax transcript obtained directly from the IRS may be used in lieu of signed tax returns, and the cost of the transcript may be charged to the borrower.

8. Qualifying Commission Income Earned for Less Than One Year

Commission income earned for less than one year is *not* considered effective income. Exceptions may be made for situations in which the borrower's compensation was changed from salary to commission within a similar position with the same employer.

A borrower may also qualify when the portion of earnings *not* attributed to commissions would be sufficient to qualify the borrower for the mortgage.

9. Employer Differential Payments

If the employer subsidizes a borrower's mortgage payment through direct payments, the amount of the payments:

- Is considered gross income, and

- Cannot be used to offset the mortgage payment directly, even if the employer pays the servicing lender directly.

10. Retirement Income

Retirement income must be verified from the former employer, or from Federal tax returns. If any retirement income, such as employer pensions or 401(k)s, will cease within the first full three years of the mortgage loan, the income may *only* be considered as a compensating factor.

11. Social Security Income

Social Security income must be verified by the Social Security Administration or on Federal tax returns. If any benefits expire within the first full three years of the loan, the income source may be considered *only* as a compensating factor.

***Notes*:**

- The lender must obtain a complete copy of the current awards letter.
- Not all Social Security income is for retirement-aged recipients; therefore, documented continuation is required.
- Some portion of Social Security income may be "grossed up" if deemed nontaxable by the IRS

12. Automobile Allowances and Expense Account Payments

Only the amount by which the borrower's automobile allowance or expense account payments *exceed* actual expenditures may be considered income.

To establish the amount to add to gross income, the borrower must provide the following:

- IRS Form 2106, *Employee Business Expenses*, for the previous two years, and

- Employer verification that the payments will continue.

If the borrower uses the standard per-mile rate in calculating automobile expenses, as opposed to the actual cost method, the portion that the IRS considers depreciation may be added back to income.

Expenses that must be treated as recurring debt include:

- The borrower's monthly car payment, and
- Any loss resulting from the calculation of the difference between the actual expenditures and the expense account allowance.

C. Borrowers Employed by a Family Owned Business

1. Income Documentation Requirement

In addition to normal employment verification, a borrower employed by a family owned businesses are required to provide evidence that he/she is not an owner of the business, which may include:

- Copies of signed personal tax returns, or
- A signed copy of the corporate tax return showing ownership percentage.

Note: A tax transcript obtained directly from the IRS may be used in lieu of signed tax returns, and the cost of the transcript may be charged to the borrower

D. General Information on Self Employed Borrowers and Income Analysis

1. Definition: Self Employed Borrower

A borrower with a 25 percent or greater ownership interest in a business is considered self employed.

2. Types of Business Structures

There are four basic types of business structures. They include:

- Sole proprietorships
- Corporations
- Limited liability or "S" corporations, and
- Partnerships.

3. Minimum Length of Self Employment

Income from self employment is considered stable, and effective, if the borrower has been self employed for two or more years.

Due to the high probability of failure during the first few years of a business, the requirements described in the table below are necessary for borrowers who have been self employed for less than two years.

If the period of self employment is ...	Then ...
Between one and two years	To be eligible for a mortgage loan, the individual must have at least two years of documented previous successful employment in the line of work in which the individual is self employed, or in a related occupation. *Note*: A combination of one year of employment and formal education or training in the line of work in which the individual is self employed or in a related occupation is also acceptable.
Less than one year	The income from the borrower may not be considered effective income.

4. General Documentation Requirements for Self Employed Borrowers

Self employed borrowers must provide the following documentation:

- Signed, dated individual tax returns, with all applicable tax schedules for the most recent two years

- For a corporation, "S" corporation, or partnership, signed copies of Federal business income tax returns for the last two years, with all applicable tax schedules
- Year to date profit and loss (P&L) statement and balance sheet, and
- Business credit report for corporations and "S" corporations.

5. Establishing a Borrower's Earnings Trend

When qualifying a borrower for a mortgage loan, the lender must establish the borrower's earnings trend from the previous two years using the borrower's tax returns.

If a borrower:

- Provides quarterly tax returns, the income analysis may include income through the period covered by the tax filings, or
- Is *not* subject to quarterly tax returns, or does not file them, then the income shown on the P&L statement may be included in the analysis, provided the income stream based on the P&L is consistent with the previous years' earnings.

If the P&L statements submitted for the current year show an income stream considerably *greater* than what is supported by the previous year's tax returns, the lender must base the income analysis solely on the income verified through the tax returns.

If the borrower's earnings trend for the previous two years is *downward* and the most recent tax return or P&L is *less than the prior year's tax return*, the borrower's most recent year's tax return or P&L must be used to calculate his/her income.

6. Analyzing the Business's Financial Strength

To determine if the business is expected to generate sufficient income for the borrower's needs, the lender must carefully analyze the business's financial strength, including the:

- Source of the business's income
- General economic outlook for similar businesses in the area.

Annual earnings that are stable or increasing are acceptable, while businesses that show a significant decline in income over the analysis period are not acceptable.

E. Income Analysis: Individual Tax Returns (IRS Form 1040)

1. General Policy on Adjusting Income Based on a Review of IRS Form 1040

The amount shown on a borrower's IRS Form 1040 as *adjusted gross income* must either be increased or decreased based on the lender's analysis of the individual tax return and any related tax schedules.

2. Guidelines for Analyzing IRS Form 1040

The table below contains guidelines for analyzing IRS Form 1040:

IRS Form 1040 Heading	Description
Wages, Salaries and Tips	An amount shown under this heading may indicate that the individual • Is a salaried employee of a corporation, or • Has other sources of income. This section may also indicate that the spouse is employed, in which case the spouse's income must be subtracted from the borrower's adjusted gross income.
Business Income and Loss (from Schedule C)	Sole proprietorship income calculated on Schedule C is business income. Depreciation or depletion may be added back to the adjusted gross income.
Rents, Royalties,	Any income received from rental properties or royalties

IRS Form 1040 Heading	Description
Partnerships (from Schedule E)	may be used as income, after adding back any depreciation shown on Schedule E.
Capital Gain and Losses (from Schedule D)	Capital gains or losses generally occur only one time, and should not be considered when determining effective income. However, if the individual has a constant turnover of assets resulting in gains or losses, the capital gain or loss must be considered when determining the income. Three years' tax returns are required to evaluate an earning trend. If the trend • Results in a gain, it may be added as effective income, or • Consistently shows a loss, it must be deducted from the total income. Lender must document anticipated continuation of income through verified assets. *Example*: A lender can consider the capital gains for an individual who purchases old houses, remodels them, and sells them for profit.
Interest and Dividend Income (from Schedule B)	This taxable/tax-exempt income may be added back to the adjusted gross income only if it • Has been received for the past two years, and • Is expected to continue. If the interest-bearing asset will be liquidated as a source of the cash investment, the lender must appropriately adjust the amount.
Farm Income or Loss (from Schedule F)	Any depreciation shown on Schedule F may be added back to the adjusted gross income.
IRA Distributions, Pensions, Annuities, and Social Security Benefits	The non-taxable portion of these items may be added back to the adjusted gross income, if the income is expected to continue for the first three years of the mortgage.
Adjustments to Income	Adjustments to income may be added back to the adjusted gross income if they are

IRS Form 1040 Heading	Description
	• IRA and Keogh retirement deductions • Penalties on early withdrawal of savings • Health insurance deductions, and • Alimony payments.
Employee Business Expenses	Employee business expenses are actual cash expenses that must be deducted from the adjusted gross income.

F. Income Analysis: Corporate Tax Returns (IRS Form 1120)

1. Description: Corporation

A ***Corporation*** is a state-chartered business owned by its stockholders.

2. Need to Obtain Borrower Percentage of Ownership Information

Corporate compensation to the officers, generally in proportion to the percentage of ownership, is shown on the

- Corporate tax return IRS Form 1120, and
- Individual tax returns.

When a borrower's percentage of ownership does not appear on the tax returns, the lender *must* obtain the information from the corporation's accountant, along with evidence that the borrower has the right to any compensation.

3. Analyzing Corporate Tax Returns

In order to determine a borrower's self employed income from a corporation the adjusted business income must

- Be determined, and
- Multiplied by the borrower's percentage of ownership in the business.

The table below describes the items found on IRS Form 1120 for which an adjustment must be made in order to determine adjusted business income.

Adjustment Item	Description of Adjustment
Depreciation and Depletion	Add the corporation's depreciation and depletion back to the after-tax income.
Taxable Income	Taxable income is the corporation's net income before Federal taxes. Reduce taxable income by the tax liability.
Fiscal Year vs. Calendar Year	If the corporation operates on a fiscal year that is different from the calendar year, an adjustment must be made to relate corporate income to the individual tax return.
Cash Withdrawals	The borrower's withdrawal of cash from the corporation may have a severe negative impact on the corporation's ability to continue operating.

G. Income Analysis: "S" Corporation Tax Returns (IRS Form 1120S)

1. Description: "S" Corporation

An ***"S" Corporation*** is generally a small, start-up business, with gains and losses passed to stockholders in proportion to each stockholder's percentage of business ownership.

Income for owners of "S" corporations comes from W-2 wages, and is taxed at the individual rate. The IRS Form 1120S, *Compensation of Officers* line item is transferred to the borrower's individual IRS Form 1040.

2. Analyzing "S" Corporation Tax Returns

"S" corporation depreciation and depletion may be added back to income in proportion to the borrower's share of the corporation's income.

In addition, the income must also be reduced proportionately by the total obligations payable by the corporation in less than one year.

IMPORTANT: The borrower's withdrawal of cash from the corporation may have a severe negative impact on the corporation's ability to continue operating, and must be considered in the income analysis.

H. Income Analysis: Partnership Tax Returns (IRS Form 1065)

1. Description: Partnership

A ***Partnership*** is formed when two or more individuals form a business, and share in profits, losses, and responsibility for running the company.

Each partner pays taxes on his/her proportionate share of the partnership's net income.

2. Analyzing Partnership Tax Returns

Both general and limited partnerships report income on IRS Form 1065, and the partners' share of income is carried over to Schedule E of IRS Form 1040.

The lender must review IRS Form 1065 to assess the viability of the business. Both depreciation and depletion may be added back to the income in proportion to the borrower's share of income.

Income must also be reduced proportionately by the total obligations payable by the partnership in less than one year.

IMPORTANT: Cash withdrawals from the partnership may have a severe negative impact on the partnership's ability to continue operating, and must be considered in the income analysis.

III. Non-Employment Related Borrower Income

A. Alimony, Child Support, and Maintenance Income Criteria

Alimony, child support, or maintenance income may be considered effective, if:

- Payments are likely to be received consistently for the first three years of the mortgage
- The borrower provides the required documentation, which includes a copy of the
    - Final divorce decree
    - Legal separation agreement,
    - Court order, or
    - Voluntary payment agreement, and
- The borrower can provide acceptable evidence that payments have been received during the last 12 months, such as
    - Cancelled checks
    - Deposit slips
    - Tax returns, or
    - Court records.

Notes:

- Periods less than 12 months may be acceptable, provided the lender can adequately document the payer's ability and willingness to make timely payments.
- Child support may be "grossed up" under the same provisions as non-taxable income sources.

B. Investment and Trust Income

1. Analyzing Interest and Dividends

Interest and dividend income may be used as long as tax returns or account statements support a two-year receipt history. This income must be averaged over the two years.

Subtract any funds that are derived from these sources, and are required for the cash investment, before calculating the projected interest or dividend income.

2. Trust Income

Income from trusts may be used if guaranteed, constant payments will continue for at least the first three years of the mortgage term.

Required trust income documentation includes a copy of the Trust Agreement or other trustee statement, confirming the

- Amount of the trust
- Frequency of distribution, and
- Duration of payments.

Trust account funds may be used for the required cash investment if the borrower provides adequate documentation that the withdrawal of funds will not negatively affect income. The borrower may use funds from the trust account for the required cash investment, but the trust income used to determine repayment ability cannot be affected negatively by its use.

3. Notes Receivable Income

In order to include notes receivable income to qualify a borrower, he/she must provide

- A copy of the note to establish the amount and length of payment, and

- Evidence that these payments have been consistently received for the last 12 months through
    - Deposit slips
    - Cancelled checks, or
    - Tax returns.

If the borrower is not the original payee on the note, the lender must establish that the borrower is now a holder in due course, and able to enforce the note.

4. Eligible Investment Properties

Follow the steps in the table below to calculate an investment property's income or loss if the property to be subject to a mortgage is an eligible investment property.

Step	Action
1	Subtract the monthly payment (PITI) from the monthly net rental income of the subject property. *Note*: Calculate the monthly net rental by taking the gross rents, and subtracting the 25 percent reduction for vacancies and repairs.
2	Does the calculation in Step 1 yield a positive number? • If *yes*, add the number to the borrower's monthly gross income. • If *no*, and the calculation yields a negative number, consider it a recurring monthly obligation.

C. Military, Government Agency, and Assistance Program Income

1. Military Income

Military personnel not only receive base pay, but often times are entitled to additional forms of pay, such as

- Income from variable housing allowances
- Clothing allowances

- Flight or hazard pay
- Rations, and
- Proficiency pay.

These types of additional pay are acceptable when analyzing a borrower's income as long as the probability of such pay to continue is verified in writing.

Note: The tax-exempt nature of some of the above payments should also be considered.

2. VA Benefits

Direct compensation for service-related disabilities from the Department of Veterans Affairs (VA) is acceptable, provided the lender receives documentation from the VA.

Education benefits used to offset education expenses are *not* acceptable.

3. Government Assistance Programs.

Income received from government assistance programs is acceptable as long as the paying agency provides documentation indicating that the income is expected to continue for at least three years.

If the income from government assistance programs will not be received for at least three years, it may be considered as a compensating factor.

Unemployment income *must* be documented for two years, and there must be reasonable assurance that this income will continue. This requirement may apply to seasonal employment.

4. Mortgage Credit Certificates

If a government entity subsidizes the mortgage payments either through direct payments or tax rebates, these payments may be considered as acceptable income.

Either type of subsidy may be added to gross income, or used directly to offset the mortgage payment, before calculating the qualifying ratios.

5. Homeownership Subsidies

A monthly subsidy may be treated as income, if a borrower is receiving subsidies under the housing choice voucher home ownership option from a public housing agency (PHA). Although continuation of the homeownership voucher subsidy beyond the first year is subject to Congressional appropriation, for the purposes of underwriting, the subsidy will be assumed to continue for at least three years.

If the borrower is receiving the subsidy directly, the amount received is treated as income. The amount received may also be treated as non taxable income and be "grossed up" by 25 percent, which means that the amount of the subsidy, plus 25 percent of that subsidy may be added to the borrower's income from employment and/or other sources.

Lenders may treat this subsidy as an "offset" to the monthly mortgage payment (that is, reduce the monthly mortgage payment by the amount of the home ownership assistance payment before dividing by the monthly income to determine the payment-to-income and debt-to-income ratios). The subsidy payment must not pass through the borrower's hands.

The assistance payment must be:

- Paid directly to the servicing lender, or
- Placed in an account that only the servicing lender may access.

Note: Assistance payments made directly to the borrower *must* be treated as income.

D. Rental Income

1. Analyzing the Stability of Rental Income

Rent received for properties owned by the borrower is acceptable as long as the lender can document the stability of the rental income through

- A current lease
- An agreement to lease, or
- A rental history over the previous 24 months that is free of unexplained gaps greater than three months (such gaps could be explained by student, seasonal, or military renters, or property rehabilitation).

A separate schedule of real estate is not required for rental properties as long as all properties are documented on the URLA.

Note: The underwriting analysis may *not* consider rental income from any property being vacated by the borrower, except under the circumstances described below.

2. Rental Income from Borrower Occupied Property

The rent for multiple unit property where the borrower resides in one or more units and charges rent to tenants of other units may be used for qualifying purposes.

Projected rent for the tenant-occupied units *only* may:

- Be considered gross income, only after deducting vacancy and maintenance factors, and
- *Not* be used as a direct offset to the mortgage payment.

3. Income from Roommates in a Single Family Property

Income from roommates in a single family property occupied as the borrower's primary residence is *not* acceptable. Rental income from boarders however, *is* acceptable, if the boarders are related by blood, marriage, or law.

The rental income may be considered effective, if shown on the borrower's tax return. If not on the tax return, rental income paid by the boarder

- May be considered a compensating factor, and
- Must be adequately documented by the lender.

4. Documentation Required to Verify Rental Income

Analysis of the following required documentation is necessary to verify all borrower rental income:

- IRS Form 1040 Schedule E; and
- Current leases/rental agreements.

5. Analyzing IRS Form 1040 Schedule E

The IRS Form 1040 Schedule E is required to verify all rental income. Depreciation shown on Schedule E may be added back to the net income or loss.

Positive rental income is considered gross income for qualifying purposes, while negative income must be treated as a recurring liability.

The lender *must* confirm that the borrower still owns each property listed, by comparing Schedule E with the real estate owned section of the URLA. If the borrower owns six or more units in the same general area, a map must be provided disclosing the locations of the.

6. Using Current Leases to Analyze Rental Income

The borrower can provide a current signed lease or other rental agreement for a property that was acquired since the last income tax filing, and is not shown on Schedule E.

In order to calculate the rental income:

- Reduce the gross rental amount by 25 percent for vacancies and maintenance
- Subtract PITI and any homeowners' association dues, and
- Apply the resulting amount to
    - Income, if positive, or
    - Recurring debts, if negative.

7. Exclusion of Rental Income from Property Being Vacated by the Borrower

Underwriters may *not* consider any rental income from a borrower's principal residence that is being vacated in favor of another principal residence, except under the conditions described below:

Notes:

- This policy assures that a borrower either has sufficient income to make both mortgage payments without any rental income, or has an equity position not likely to result in defaulting on the mortgage on the property being vacated.
- This applies *solely* to a principal residence being vacated in favor of another principal residence. It does *not* apply to existing rental properties disclosed on the loan application and confirmed by tax returns (Schedule E of form IRS 1040).

8. Policy Exceptions Regarding the Exclusion of Rental Income from a Principal Residence Being Vacated by a Borrower

When a borrower vacates a principal residence in favor of another principal residence, the rental income, reduced by the appropriate vacancy factor, *may* be considered in the underwriting analysis under the circumstances listed in the table below.

Exception	**Description**
Relocations	The borrower is relocating with a new employer, or being transferred by the current employer to an area not within reasonable and locally-recognized commuting distance. A properly executed lease agreement (that is, a lease signed by the borrower and the lessee) of at least one year's duration after the loan is closed is required. *Note*: Underwriters should also obtain evidence of the security deposit and/or evidence the first month's rent was paid to the homeowner.
Sufficient Equity in Vacated Property	The borrower has a loan-to-value ratio of 75 percent or less, as determined either by • A current (no more than six months old) residential appraisal, or • Comparing the unpaid principal balance to the original sales price of the property. *Note*: The appraisal, in addition to using forms Fannie Mae1004/Freddie Mac 70, may be an exterior-only appraisal using form Fannie Mae/Freddie Mac 2055, and for condominium units, form Fannie Mae1075/Freddie Mac 466.

E. Non Taxable and Projected Income

1. Types of Non Taxable Income

Certain types of regular income may not be subject to Federal tax. Such types of non taxable income include

- Some portion of Social Security, some Federal government employee retirement income, Railroad Retirement Benefits, and some state government retirement income

- Certain types of disability and public assistance payments
- Child support
- Military allowances, and
- Other income that is documented as being exempt from Federal income taxes.

2. Adding Non Taxable Income to a Borrower's Gross Income

The amount of continuing tax savings attributed to regular income not subject to Federal taxes may be added to the borrower's gross income.

The percentage of non-taxable income that may be added *cannot* exceed the appropriate tax rate for the income amount. Additional allowances for dependents are *not* acceptable.

The lender:

- Must document and support the amount of income *grossed up* for any non-taxable income source, and
- Should use the tax rate used to calculate the borrower's last year's income tax.

Note: If the borrower is not required to file a Federal tax return, the tax rate to use is 25 percent.

3. Analyzing Projected Income

Projected or hypothetical income is *not* acceptable for qualifying purposes. However, exceptions are permitted for income from the following sources:

- Cost-of-living adjustments
- Performance raises, and
- Bonuses.

For the above exceptions to apply, the income must be

- Verified in writing by the employer, and
- Scheduled to begin within 60 days of loan closing.

4. Project Income for New Job

Projected income is acceptable for qualifying purposes for a borrower scheduled to start a new job within 60 days of loan closing if there is a guaranteed, non-revocable contract for employment.

The lender *must* verify that the borrower will have sufficient income or cash reserves to support the mortgage payment and any other obligations between loan closing and the start of employment. Examples of this type of scenario are teachers whose contracts begin with the new school year, or physicians beginning a residency after the loan closes fall under this category.

The loan is *not eligible for endorsement* if the loan closes more than 60 days before the borrower starts the new job. To be eligible for endorsement, the lender must obtain from the borrower a pay stub or other acceptable evidence indicating that he/she has started the new job.

IV. Borrower Liabilities: Recurring Obligations

1. Types of Recurring Obligations

Recurring obligations include:

- All installment loans
- Revolving charge accounts
- Real estate loans
- Alimony

- Child support, and
- Other continuing obligations.

2. Debt to Income Ratio Computation for Recurring Obligations

The lender must include the following when computing the debt to income ratios for recurring obligations:

- Monthly housing expense, and
- Additional recurring charges extending ten months or more, such as
    - Payments on installment accounts
    - Child support or separate maintenance payments
    - Revolving accounts, and
    - Alimony.

Debts lasting less than ten months must be included if the amount of the debt affects the borrower's ability to pay the mortgage during the months immediately after loan closing, especially if the borrower will have limited or no cash assets after loan closing.

Note: Monthly payments on revolving or open-ended accounts, regardless of the balance, are counted as a liability for qualifying purposes even if the account appears likely to be paid off within 10 months or less.

3. Revolving Account Monthly Payment Calculation

If the credit report shows any revolving accounts with an outstanding balance but no specific minimum monthly payment, the payment must be calculated as the greater of

- 5 percent of the balance, or
- $10.

Note: If the actual monthly payment is documented from the creditor or the lender obtains a copy of the current statement reflecting the monthly payment, that amount may be used for qualifying purposes.

4. Reduction of Alimony Payment for Qualifying Ratio Calculation

Since there are tax consequences of alimony payments, the lender may choose to treat the monthly alimony obligation as a reduction from the borrower's gross income when calculating qualifying ratios, rather than treating it as a monthly obligation.

V. Borrower Liabilities: Contingent Liability

1. Definition: Contingent Liability

A contingent liability exists when an individual is held responsible for payment of a debt if another party, jointly or severally obligated, defaults on the payment.

2. Application of Contingent Liability Policies

The contingent liability policies described in this topic apply unless the borrower can provide conclusive evidence from the debt holder that there is no possibility that the debt holder will pursue debt collection against him/her should the other party default.

3. Contingent Liability on Mortgage Assumptions

Contingent liability must be considered when the borrower remains obligated on an outstanding FHA-insured, VA-guaranteed, or conventional mortgage secured by property that:

- Has been sold or traded within the last 12 months without a release of liability, or
- Is to be sold on assumption without a release of liability being obtained.

4. Exemption from Contingent Liability Policy on Mortgage Assumptions

When a mortgage is assumed, contingent liabilities need not be considered if the

- Originating lender of the mortgage being underwritten obtains, from the servicer of the assumed loan, a payment history showing that the mortgage has been current during the previous 12 months, or
- Value of the property, as established by an appraisal or the sales price on the HUD-1 *Settlement Statement* from the sale of the property, results in a loan-to-value (LTV) ratio of 75 percent or less.

5. Contingent Liability on Cosigned Obligations

Contingent liability applies, and the debt must be included in the underwriting analysis, if an individual applying for a mortgage is a cosigner/co-obligor on:

- A car loan
- A student loan
- A mortgage, or
- Any other obligation.

If the lender obtains documented proof that the primary obligor has been making regular payments during the previous 12 months, and does not have a history of delinquent payments on the loan during that time, the payment does not have to be included in the borrower's monthly obligations.

VI. Borrower Liabilities: Projected Obligations and Obligations Not Considered Debt

1. Projected Obligations

Debt payments, such as a student loan or balloon note scheduled to begin or come due within 12 months of the mortgage loan closing, must be included by the lender as anticipated monthly obligations during the underwriting analysis.

Debt payments do not have to be classified as projected obligations if the borrower provides written evidence that the debt will be deferred to a period outside the 12-month timeframe.

Balloon notes that come due within one year of loan closing must be considered in the underwriting analysis.

2. Obligations Not Considered Debt

Obligations not considered debt, and therefore not subtracted from gross income, include

- Federal, state, and local taxes
- Federal Insurance Contributions Act (FICA) or other retirement contributions, such as 401(k) accounts (including repayment of debt secured by these funds)
- Commuting costs
- Union dues
- Open accounts with zero balances
- Automatic deductions to savings accounts
- Child care, and
- Voluntary deductions.

END OF COMMON RULE

[END OF COMMON TEXT]

List of Subjects

Adoption of the Common Rule Text

The proposed adoption of the common rules by the agencies, as modified by agency-specific text, is set forth below:

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Chapter I

Authority and Issuance

For the reasons stated in the Common Preamble, the Office of the Comptroller of the Currency proposes to amend chapter I of Title 12, Code of Federal Regulations as follows:

PART 43 – CREDIT RISK RETENTION

1. The authority for part 43 is added to read as follows:

Authority: 12 U.S.C. 1 et seq., 93a, 161, 1818, and 15 U.S.C. 78o-11.

2. Part 43 is added as set forth at the end of the Common Preamble.

3. Section 43.1 is revised to read as follows:

§ 43.1 Authority, purpose, scope, and reservation of authority.

(a) Authority. This part is issued under the authority of 12 U.S.C. 1 et seq., 93a, 161, 1818, and 15 U.S.C. 78o-11.

(b) Purpose. (1) This part requires securitizers to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party. This part specifies the permissible types, forms, and amounts of credit risk retention, and it establishes certain exemptions for securitizations collateralized by assets that meet specified underwriting standards.

(2) Nothing in this part shall be read to limit the authority of the OCC to take supervisory or enforcement action, including action to address unsafe or unsound practices or conditions, or violations of law.

(c) Scope. This part applies to any securitizer that is a national bank, a Federal branch or agency of a foreign bank, or an operating subsidiary thereof.

(d) Effective dates. This part shall become effective:

(1) With respect to any securitization transaction collateralized by residential mortgages, one year after the date on which final rules under section 15G(b) of the Exchange Act (15 U.S.C. 78o-11(b)) are published in the Federal Register; and

(2) With respect to any other securitization transaction, two years after the date on which final rules under section 15G(b) of the Exchange Act (15 U.S.C. 78o-11(b)) are published in the Federal Register.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

12 CFR Chapter II

Authority and Issuance

For the reasons set forth in the Supplementary Information, the Board of Governors of the Federal Reserve System proposes to add the text of the common rule as set forth at the end of the Supplementary Information as Part 244 to chapter II of Title 12, Code of Federal Regulations, modified as follows:

PART 244 — CREDIT RISK RETENTION (REGULATION RR)

4. The authority citation for part 244 is added to reads as follows:

Authority: 12 U.S.C. 221 et seq., 1818, 1841 et seq., 3103 et seq., and 15 U.S.C. 78o-11.

5. Section 244.1 is amended to read as follows:

§ 244.1 Authority, purpose, and scope

(a) Authority. (1) In general. This part (Regulation RR) is issued by the Board of Governors of the Federal Reserve System under section 15G of the Securities Exchange Act of 1934, as amended (Exchange Act) (15 U.S.C. 78o-11), as well as under the Federal Reserve Act, as amended (12 U.S.C. 221 et seq.); section 8 of the Federal Deposit Insurance Act (FDI Act), as amended (12 U.S.C. 1818); the Bank Holding Company Act of 1956, as amended (BHC Act) (12 U.S.C. 1841 et seq.); and the International Banking Act of 1978, as amended (12 U.S.C. 3101 et seq.).

(2) Nothing in this part shall be read to limit the authority of the Board to take action under provisions of law other than 15 U.S.C. 78o-11, including action to address unsafe or unsound practices or conditions, or violations of law or regulation, under section 8 of the FDI Act.

(b) Purpose. This part requires any securitizer to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party in a transaction within the scope of section 15G of the Exchange Act. This part specifies the permissible types, forms, and amounts of credit risk retention, and establishes certain exemptions for securitizations collateralized by assets that meet specified underwriting standards or that otherwise qualify for an exemption.

(c) Scope. (1) This part applies to any securitizer that is:

(i) A state member bank (as defined in 12 CFR 208.2(g)); or

(ii) Any subsidiary of a state member bank.

(2) Section 15G of the Exchange Act and the rules issued thereunder apply to any securitizer that is:

(i) A bank holding company (as defined in 12 U.S.C. 1842);

(ii) A foreign banking organization (as defined in 12 CFR 211.21(o));

(iii) An Edge or agreement corporation (as defined in 12 CFR 211.1(c)(2) and (3));

(iv) A nonbank financial company that the Financial Stability Oversight Council has determined under section 113 of the Dodd–Frank Wall Street Reform and Consumer Protection Act (the Dodd–Frank Act) (12 U.S.C. 5323) shall be supervised by the Board and for which such determination is still in effect; or

(v) Any subsidiary of the foregoing. The Federal Reserve will enforce section 15G of the Exchange Act and the rules issued thereunder under section 8 of the FDI Act against any of the foregoing entities.

(3) On and after the transfer date established under section 311 of the Dodd-Frank Act (12 U.S.C. 5411), the Federal Reserve will enforce section 15G of the Exchange Act and the rules issued thereunder under section 8 of the FDI Act against any securitizer that is a savings and loan holding company and any subsidiary thereof (as defined in 12 U.S.C. 1467a).

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Chapter III

Authority and Issuance

For the reasons set forth in the Supplementary Information, the Federal Deposit Insurance Corporation proposes to add the text of the common rule as set forth at the end of the Supplementary Information as Part 373 to chapter III of Title 12, Code of Federal Regulations, modified as follows:

PART 373 — CREDIT RISK RETENTION

6. The authority citation for part [ ] is added to reads as follows:

Authority: 12 U.S.C. 1801 et seq. and 3103 et seq., and 15 U.S.C. 78o-11.

7. Section 373.1 is amended to read as follows:

§ 373.1 Purpose and scope

(a) Authority. (1) In general. This part is issued by the Federal Deposit Insurance Corporation (FDIC) under section 15G of the Securities Exchange Act of 1934, as amended (Exchange Act) (15 U.S.C. 78o-11), as well as the Federal Deposit Insurance Act (12 U.S.C. 1801 et seq.) and the International Banking Act of 1978, as amended (12 U.S.C. 3101 et seq.).

(2) Nothing in this part shall be read to limit the authority of the FDIC to take action under provisions of law other than 15 U.S.C. 78o-11, including to address unsafe or unsound practices or conditions, or violations of law or regulation under section 8 of the Federal Deposit Insurance Act (12 U.S.C. 1818).

(b) Purpose. (1) This part requires securitizers to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party in a transaction within the scope of section 15G of the Exchange Act. This part specifies the permissible types, forms, and amounts of credit risk retention, and it establishes certain exemptions for securitizations collateralized by assets that meet specified underwriting standards or that otherwise qualify for an exemption.

(c) Scope. This part applies to any securitizer that is:

(1) A state nonmember bank (as defined in 12 U.S.C. 1813(e)(2));

(2) An insured federal or state branch of a foreign bank (as defined in 12 CFR 347.202); or

(3) Any subsidiary of the foregoing.

SECURITIES AND EXCHANGE COMMISSION

For the reasons stated in the Supplementary Information, the Securities and Exchange Commission proposes the amendments under the authority set forth in Sections 7, 10, 19(a), and 28 of the Securities Act and Sections 3, 13, 15, 15G, 23 and 36 of the Exchange Act.

List of Subjects

17 CFR Part 246

Reporting and recordkeeping requirements, Securities.

For the reasons set out above, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 246 — CREDIT RISK RETENTION

8. The authority citation for part 246 is added to read as follows:

Authority: 15 U.S.C. 77g, 77j, 77s, 77z-3, 78c, 78m, 78o, 78o-11, 78w, 78mm

9. Part 246 is added to read as follows:

17 CFR § 246.1

(a) Authority and purpose. This part (Regulation RR) is issued by the Securities and Exchange Commission ("Commission") jointly with the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and, in the case of the securitization of any residential mortgage asset, together with the Secretary of Housing and Urban Development and the Federal Housing Finance Agency, pursuant to Section 15G of the Securities Exchange Act of 1934 (15 U.S.C. §78o-11). The Commission also is issuing this part pursuant to its authority under Sections 7, 10, 19(a), and 28 of the Securities Act and Sections 3, 13, 15, 23, and 36 of the Exchange Act. This part requires securitizers to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party. This part specifies the permissible types, forms, and amounts of credit risk retention, and establishes certain exemptions for securitizations collateralized by assets that meet specified underwriting standards or otherwise qualify for an exemption.

(b) The authority of the Commission under this part shall be in addition to the authority of the Commission to otherwise enforce the federal securities laws, including, without limitation, the antifraud provisions of the securities laws.

FEDERAL HOUSING FINANCE AGENCY

List of Subjects

12 CFR Part 1234

Government sponsored enterprises, mortgages, securities.

For the reasons stated in the Supplementary Information, and under the authority of 12 U.S.C. 4526, the Federal Housing Finance Agency proposes to add the text of the common rule as set forth at the end of the Supplementary Information as Part 1234 of subchapter B of chapter XII of title 12 of the Code of Federal Regulations, modified as follows:

CHAPTER XII – FEDERAL HOUSING FINANCE AGENCY

SUBCHAPTER B – ENTITY REGULATIONS

PART 1234 — CREDIT RISK RETENTION

10. The authority citation for part 1234 is added to reads as follows:

Authority: 12 U.S.C. 4511(b), 4526, 4617; 15 U.S.C. 78o-11(b)(2).

11. Section 1234.1 is revised to read as follows:

§ 1234.1 Purpose, scope and reservation of authority.

(a) Purpose. This part requires securitizers to retain an economic interest in a portion of the credit risk for any residential mortgage asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party in a transaction within the scope of section 15G of the Exchange Act. This part specifies the permissible types, forms, and amounts of credit risk retention, and it establishes certain exemptions for securitizations collateralized by assets that meet specified underwriting standards or that otherwise qualify for an exemption.

(b) Scope. Effective [INSERT DATE ONE YEAR AFTER PUBLICATION IN THE FEDERAL REGISTER AS A FINAL RULE], this part will apply to any securitizer that is an entity regulated by the Federal Housing Finance Agency.

(c) Reservation of authority. Nothing in this part shall be read to limit the authority of the Director of the Federal Housing Finance Agency to take supervisory or enforcement action, including action to address unsafe or unsound practices or conditions, or violations of law.

§ 1234.16 [Amended]

3. Amend § 1234.16 as follows:

a. In the heading, remove the words ", commercial loans, and auto loans".

b. In the introductory paragraph, remove the words "§ 1234.17 through § 1234.20" and add in their place the words "§ 1234.19".

c. Remove the definitions of "Automobile loan", "Commercial loan", "Debt-to-income (DTI) ratio", "Earnings before interest, taxes, depreciation, and amortization (EBITDA)", "Leverage Ratio", "Machinery and equipment (M&E) collateral", "Model year", "New vehicle", "Payment-in-kind (PIK)", "Purchase price", "Salvage title", "Total debt", "Total liabilities ratio", "Trade-in allowance" and "Used vehicle".

d. Revise the definition of "Debt service coverage (DSC) ratio" to read as follows:

Debt service coverage (DSC) ratio means the ratio of:

(1) The annual NOI less the annual replacement reserve of the CRE property at the time of origination of the CRE loans; to

(2) The sum of the borrower's annual payments for principal and interest on any debt obligation.

4. Reserve §§ 1234.17, 1234.18 and 1234.20.

§ 1234.19 [Amended]

5. Amend § 1234.19 as follows:

a. In the heading, remove the words "Underwriting standards" and, in their place, add the word "Exception".

b. Add introductory text as follows: "The risk retention requirements in subpart B of this part shall not apply to securitization transactions that satisfy the standards provided in this section."

[THIS SIGNATURE PAGE RELATES TO THE PROPOSED RULE TITLED "CREDIT RISK RETENTION"]

Dated: 3/28/11

John Walsh

John Walsh,
Acting Comptroller of the Currency.

[THIS SIGNATURE PAGE RELATES TO THE PROPOSED RULE TITLED "CREDIT RISK RETENTION"]

By order of the Board of Governors of the Federal Reserve System, March 30, 2011.

Jennifer J. Johnson

Jennifer J. Johnson
Secretary of the Board

[THIS SIGNATURE PAGE RELATES TO THE PROPOSED RULE TITLED "CREDIT RISK RETENTION"]

Dated at Washington, D.C., this 29th day of March 2011.

By order of the Board of Directors.

Federal Deposit Insurance Corporation.

Robert E. Feldman,
Executive Secretary

[THIS SIGNATURE PAGE RELATES TO THE PROPOSED RULE TITLED "CREDIT RISK RETENTION"]

Edward J. DeMarco

Edward J. Demarco

Acting Director, Federal Housing Finance Agency.

3-29-2011

Date

[THIS SIGNATURE PAGE PERTAINS TO THE SECURITIES AND EXCHANGE COMMISSION'S PORTION OF THE JOINT PROPOSED RULES ENTITLED "CREDIT RISK RETENTION"]

By the Securities and Exchange Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Date: March 30, 2011

[THIS SIGNATURE PAGE RELATES TO THE PROPOSED RULE TITLED "CREDIT RISK RETENTION"].

By the Department of Housing and Urban Development

3/31/11

Shaun Donovan,
Secretary

Date

Commissioner Casey, Commissioner Paredes Disapproved

DEPARTMENT OF THE TREASURY
Office of the Comptroller of the Currency
12 CFR Part 42
Docket No. OCC-2011-0001
RIN 1557-AD39

FEDERAL RESERVE SYSTEM
12 CFR Part 236
Docket No. R-1410
RIN 7100-AD69

FEDERAL DEPOSIT INSURANCE CORPORATION
12 CFR Part 372
RIN 3064-AD56

DEPARTMENT OF THE TREASURY
Office of Thrift Supervision
12 CFR Part 563h
Docket No. OTS-2011-0004
RIN 1550-AC49

NATIONAL CREDIT UNION ADMINISTRATION
12 CFR Parts 741 and 751
RIN 3133-AD88

SECURITIES AND EXCHANGE COMMISSION
17 CFR Part 248
[Release No. 34-64140; File no. S7-12-11]
RIN 3235-AL06

FEDERAL HOUSING FINANCE AGENCY
12CFR Part 1232
RIN 2590-AA42

Incentive-based Compensation Arrangements

AGENCIES: Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Office of Thrift Supervision, Treasury (OTS); National Credit Union Administration (NCUA); U.S. Securities and Exchange Commission (SEC); and Federal Housing Finance Agency (FHFA).

ACTION: Proposed Rule.

SUMMARY: The OCC, Board, FDIC, OTS, NCUA, SEC, and FHFA (the Agencies) are proposing rules to implement section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The proposed rule would require the reporting of incentive-based compensation arrangements by a covered financial institution and prohibit incentive-based compensation arrangements at a covered financial institution that provide excessive compensation or that could expose the institution to inappropriate risks that could lead to material financial loss.

DATES: Comments must be received by [INSERT DATE 45 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

ADDRESSES: Although the Agencies will jointly review all the comments submitted, it would facilitate review of the comments if interested parties send comments to the Agency that is the appropriate Federal regulator, as defined in section 956(e) of the Dodd-Frank Act for the type of covered financial institution addressed in the comments. Commenters are encouraged to use the title "Incentive-based Compensation Arrangements" to facilitate the organization and distribution of comments among the Agencies. Interested parties are invited to submit written comments to:

Office of the Comptroller of the Currency: Because paper mail in the Washington, DC area and at the OCC is subject to delay, commenters are encouraged to submit comments by the Federal eRulemaking Portal or e-mail, if possible. Please use the title "Incentive-based Compensation Arrangements" to facilitate the organization and distribution of the comments. You may submit comments by any of the following methods:

- Federal eRulemaking Portal—Regulations.gov: Go to http://www.regulations.gov. Select "Document Type" of "Proposed Rule", and in "Enter Keyword or ID Box", enter Docket ID "OCC-2011-0001", and click "Search." On "View By Relevance" tab at bottom of screen, in the "Agency" column, locate the proposed rule for OCC, in the "Action" column, click on "Submit a Comment" or "Open Docket Folder" to submit or view public comments and to view supporting and related materials for this proposed rule.
- Click on the "Help" tab on the Regulations.gov home page to get information on using Regulations.gov, including instructions for submitting or viewing public comments, viewing other supporting and related materials, and viewing the docket after the close of the comment period.
- E-mail: regs.comments@occ.treas.gov.
- Mail: Office of the Comptroller of the Currency, 250 E Street, SW., Mail Stop 2-3, Washington, DC 20219.
- Fax: (202) 874-5274.
- Hand Delivery/Courier: 250 E Street, SW., Mail Stop 2-3, Washington, DC 20219.

Instructions: You must include "OCC" as the agency name and "Docket ID OCC-2011-0001" in your comment. In general, OCC will enter all comments received into the docket and publish them on the Regulations.gov Web site without change, including any business or personal information that you provide such as name and address information, e-mail addresses, or phone numbers. Comments received, including attachments and other supporting materials, are part of the public record and subject to public disclosure.

Do not enclose any information in your comment or supporting materials that you consider confidential or inappropriate for public disclosure.

You may review comments and other related materials that pertain to this proposed rule by any of the following methods:

- Viewing Comments Electronically: Go to http://www.regulations.gov. Select "Document Type" of "Public Submission," in "Enter Keyword or ID Box," enter Docket ID "OCC-2011-0001", and click "Search." Comments will be listed under "View By Relevance" tab at bottom of screen. If comments from more than one agency are listed, the "Agency" column will indicate which comments were received by the OCC.
- Viewing Comments Personally: You may personally inspect and photocopy comments at the OCC, 250 E Street, SW., Washington, DC. For security reasons, the OCC requires that visitors make an appointment to inspect comments. You may do so by calling (202) 874-4700. Upon arrival, visitors will be required to present valid government-issued photo identification and to submit to security screening in order to inspect and photocopy comments.
- Docket: You may also view or request available background documents and project summaries using the methods described above.

Board of Governors of the Federal Reserve System: You may submit comments, identified by Docket No. R-1410 and RIN No. 7100-AD69, by any of the following methods:

- Agency Web Site: http://www.federalreserve.gov. Follow the instructions for submitting comments at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm.

- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- E-mail: regs.comments@federalreserve.gov. Include the docket number and RIN number in the subject line of the message.
- Fax: (202) 452-3819 or (202) 452-3102.
- Mail: Address to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551.

All public comments will be made available on the Board's website at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm as submitted, unless modified for technical reasons. Accordingly, comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper in Room MP-500 of the Board's Martin Building (20th and C Streets, NW.) between 9:00 a.m. and 5:00 p.m. on weekdays.

Federal Deposit Insurance Corporation: You may submit comments, identified by RIN number, by any of the following methods:

- Agency Web Site: http://www.FDIC.gov/regulations/laws/federal/propose.html. Follow instructions for submitting comments on the Agency Web Site.
- E-mail: Comments@FDIC.gov. Include the RIN number on the subject line of the message.
- Mail: Robert E. Feldman, Executive Secretary, Attention: Comments, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

- Hand Delivery: Comments may be hand delivered to the guard station at the rear of the 550 17th Street Building (located on F Street) on business days between 7:00 a.m. and 5:00 p.m.

Instructions: All comments received must include the agency name and RIN for this rulemaking and will be posted without change to http://www.fdic.gov/regulations/laws/ federal/propose.html, including any personal information provided.

Office of Thrift Supervision: You may submit comments, identified by OTS–2011–0004, by any of the following methods:

- Federal eRulemaking Portal – Regulations.gov: Go to http://www.regulations.gov and follow the directions.
- E-mail: regs.comments@ots.treas.gov. Please include OTS–2011–0004 in the subject line of the message and include your name and telephone number in the message.
- Mail: Regulation Comments, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552, Attention: OTS–2011–0004.
- Facsimile: (202) 906–6518.
- Hand Delivery/Courier: Guard's Desk, East Lobby Entrance, 1700 G Street, NW., from 9 a.m. to 4 p.m. on business days, Attention: Regulation Comments, Chief Counsel's Office, Attention: OTS–2011–0004.
- Instructions: All submissions received must include the agency name and docket number for this rulemaking. All comments received will be entered into the

docket and posted on Regulations.gov without change, including any personal information provided. Comments, including attachments and other supporting materials received, are part of the public record and subject to public disclosure. Do not enclose any information in your comment or supporting materials that you consider confidential or inappropriate for public disclosure.

- Viewing Comments On-Site: You may inspect comments at the Public Reading Room, 1700 G Street, NW., by appointment. To make an appointment for access, call (202) 906–5922, send an e-mail to public.info@ots.treas.gov, or send a facsimile transmission to (202) 906–6518. (Prior notice identifying the materials you will be requesting will assist us in serving you.) We schedule appointments on business days between 10:00 a.m. and 4:00 p.m. In most cases, appointments will be available the next business day following the date we receive a request.

National Credit Union Administration: You may submit comments by any of the following methods (please send comments by one method only): Federal eRulemaking Portal: http:// www.regulations.gov. Follow the instructions for submitting comments.

- Agency Web site: http://www.ncua.gov/Resources/RegulationsOpinionsLaws/ProposedRegulations.aspx. Follow the instructions for submitting comments.
- E-mail: Address to regcomments@ncua.gov. Include ''[Your name] Comments on ''Notice of Proposed Rulemaking for Incentive-based Compensation Arrangements'' in the e-mail subject line.
- Fax: (703) 518–6319. Use the subject line described above for e-mail.
- Mail: Address to Mary Rupp, Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314–3428.

- Hand Delivery/Courier: Same as mail address.
- Public Inspection: All public comments are available on the agency's Web site at http://www.ncua.gov/Resources/RegulationsOpinionsLaws/ProposedRegulations.aspx as submitted, except when not possible for technical reasons. Public comments will not be edited to remove any identifying or contact information. Paper copies of comments may be inspected in NCUA's law library at 1775 Duke Street, Alexandria, Virginia 22314, by appointment weekdays between 9:00 a.m. and 3:00 p.m. To make an appointment, call (703) 518–6546 or send an e-mail to OGCMail@ncua.gov.

Securities and Exchange Commission: You may submit comments by the following method:

Electronic Comments

- Use the Commission's Internet comment form (http://www.sec.gov/rules/exorders.shtml); or
- Send an e-mail to rule-comments@sec.gov Please include File Number S7-12-11 on the subject line; or
- Use the Federal eRulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549.

All submissions should refer to File Number S7-12-11. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (http://www.sec.gov/rules/proposed.shtml). Comments are also available for Web site viewing and printing in the Commission's Public Reference Room, 100 F St., NE, Washington, DC 20549 on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

Federal Housing Finance Agency: You may submit your written comments on the proposed rulemaking, identified by RIN number 2590-AA42, by any of the following methods:

- E-mail: Comments to Alfred M. Pollard, General Counsel, may be sent by e-mail at RegComments@fhfa.gov. Please include "RIN 2590-AA42" in the subject line of the message.
- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments. If you submit your comment to the Federal eRulemaking Portal, please also send it by e-mail to FHFA at RegComments@fhfa.gov to ensure timely receipt by the Agency. Please include ''RIN 2590–AA42'' in the subject line of the message.
- U.S. Mail, United Parcel Service, Federal Express, or Other Mail Service: The mailing address for comments is: Alfred M. Pollard, General Counsel, Attention: Comments/RIN 2590-AA42, Federal Housing Finance Agency, Fourth Floor, 1700 G Street, NW., Washington, DC 20552.

- Hand Delivery/Courier: The hand delivery address is: Alfred M. Pollard, General Counsel, Attention: Comments/RIN 2590-AA42, Federal Housing Finance Agency, Fourth Floor, 1700 G Street, NW., Washington, DC 20552. A hand-delivered package should be logged at the Guard Desk, First Floor, on business days between 9:00 a.m. and 5:00 p.m.

All comments received by the deadline will be posted for public inspection on the FHFA Web site at http://www.fhfa.gov. Copies of all comments timely received will be available for public inspection and copying at the address above on government-business days between the hours of 10:00 a.m. and 3:00 p.m. To make an appointment to inspect comments please call the Office of General Counsel at (202) 414-6924.

FOR FURTHER INFORMATION CONTACT:

OCC: Michele Meyer, Assistant Director, and Patrick Tierney, Counsel, Legislative and Regulatory Activities, (202) 874-5090, and Karen Kwilosz, Director, Operational Risk Policy, (202) 874-5350, Office of the Comptroller of the Currency, 250 E Street SW., Washington, DC 20219.

BOARD: Michael Waldron, Counsel, (202) 452-2798, or Amanda Allexon, Counsel, (202) 452-3818, Legal Division; William F. Treacy, Advisor, (202) 452-3859, or Meg Donovan, Supervisory Financial Analyst, (202) 452-7542, Division of Banking Supervision and Regulation; Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington , D.C. 20551.

FDIC: Steven D. Fritts, Associate Director, Risk Management Policy Branch DSC, (202) 898-3723; Melinda West, Chief, Policy & Program Development, DSC, (202) 898-7221, George Parkerson, Senior Policy Analyst, (202) 898-3648; Rose Kushmeider, Senior

Financial Economist, (202) 898-3861; Daniel Lonergan, Counsel, (202) 898-6791, Rodney Ray, Counsel, (202) 898-3556, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

OTS: Mary Jo Johnson, Senior Project Manager, Examination Programs, (202) 906-5739, Richard Bennett, Senior Compliance Counsel, Regulations and Legislation Division, (202) 906–7409; Robyn Dennis, Director, Examination Programs, (202) 906-5751; James Caton, Managing Director, Economic and Industry Analysis, (202) 906-5680, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552.

NCUA: Regina Metz, Staff Attorney, Office of General Counsel, (703) 518-6561; or Vickie Apperson, Program Officer, Office of Examination & Insurance, (703) 518-6385, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314.

SEC: Raymond A. Lombardo, Branch Chief, Division of Trading & Markets, (202) 551-5755; Timothy C. Fox, Special Counsel, Division of Trading & Markets, (202) 551-5687; Nadya B. Roytblat, Assistant Chief Counsel, Division of Investment Management, (202) 551-6823; or Jennifer R. Porter, Attorney-Advisor, Division of Investment Management, (202) 551-6787, United States Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549.

FHFA: Alfred M. Pollard, General Counsel, (202) 414-3788 or Patrick J. Lawler, Associate Director and Chief Economist (202) 414-3746, Federal Housing Finance Agency, Fourth Floor, 1700 G Street NW., Washington, DC 20552. The telephone number of the Telecommunications Device for the Deaf is (800) 877-8339.

SUPPLEMENTARY INFORMATION:

I. BACKGROUND

Dodd-Frank Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or the "Act") (Pub. L. 111-203, section 956, 124 Stat. 1376, 2011-2018 (2010)), which was signed into law on July 21, 2010, requires the Agencies to jointly prescribe regulations or guidelines with respect to incentive-based compensation practices at covered financial institutions. Specifically, section 956 of the Dodd-Frank Act (codified at 12 U.S.C. 5641) requires that the Agencies prohibit incentive-based payment arrangements, or any feature of any such arrangement, at a covered financial institution that the Agencies determine encourages inappropriate risks by a financial institution by providing excessive compensation or that could lead to material financial loss. Under the Act, a covered financial institution also must disclose to its appropriate Federal regulator the structure of its incentive-based compensation arrangements sufficient to determine whether the structure provides "excessive compensation, fees, or benefits" or "could lead to material financial loss" to the institution. The Dodd-Frank Act does not require a covered financial institution to report the actual compensation of particular individuals as part of this requirement.

The Act defines "covered financial institution" to include any of the following types of institutions that have $1 billion or more in assets: (A) a depository institution or depository institution holding company, as such terms are defined in section 3 of the Federal Deposit Insurance Act ("FDIA") (12 U.S.C. 1813); (B) a broker-dealer registered under section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78o); (C) a credit union, as described in section 19(b)(1)(A)(iv) of the Federal Reserve Act; (D) an investment adviser, as such term is defined in section 202(a)(11) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(11)); (E) the Federal National Mortgage Association (Fannie Mae); (F) the Federal Home Loan Mortgage Corporation (Freddie Mac); and (G) any other financial institution that the appropriate Federal regulators, jointly, by rule, determine should be treated as a covered financial institution for these purposes.

The Act also requires the Agencies to ensure that any standards adopted with regard to excessive compensation under section 956 of the Act are comparable to the compensation-related safety and soundness standards applicable to insured depository institutions under section 39 of the FDIA (12 U.S.C. 1831p-1(c)),[1] and to take the compensation standards described in section 39 of the FDIA into consideration in establishing compensation standards under section 956 of the Act.

Compensation arrangements are critical tools in the successful management of financial institutions. These arrangements serve several important objectives, including attracting and retaining skilled staff, promoting better organizational and individual employee performance, and providing retirement security to employees.

At the same time, improperly structured compensation arrangements can provide executives and employees with incentives to take imprudent risks that are not consistent with the long-term health of the organization. The Agencies believe that flawed incentive

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1 The Federal banking agencies each have adopted guidelines implementing the compensation-related and other safety and soundness standards in section 39 of the FDIA. See 12 CFR part 30, Appendix A (OCC); 12 CFR part 208, Appendix D-1 (Board); 12 CFR part 364, Appendix A (FDIC); 12 CFR part 570, Appendix A (OTS).

compensation practices in the financial industry were one of many factors contributing to the financial crisis that began in 2007.

Shareholders and, for a credit union, members of a covered financial institution have an interest in aligning the interests of managers and other employees of the institution with its long-term health. Aligning the interests of shareholders or members and employees, however, is not always sufficient to protect the safety and soundness of an organization, deter excessive compensation, or deter behavior that could lead to material financial loss at the organization. Managers and employees of a covered financial institution may be willing to tolerate a degree of risk that is inconsistent with broader public policy goals. In addition, particularly at larger institutions, shareholders or members may have difficulty effectively monitoring and controlling the incentive-based compensation arrangements throughout the institution that may materially affect the institution's risk profile, even with increased disclosure provisions. As a result, supervision and regulation of incentive compensation, as with other aspects of financial oversight, can play an important role in helping ensure that incentive compensation practices at covered financial institutions do not threaten their safety and soundness, are not excessive, or do not lead to material financial loss.

II. OVERVIEW OF THE PROPOSED RULE

The Agencies have elected to propose rules, rather than guidelines, in order to establish general requirements applicable to the incentive-based compensation arrangements of all covered financial institutions ("Proposed Rule"). The Proposed Rule would supplement existing rules, guidance, and ongoing supervisory efforts of the Agencies.

The Proposed Rule has the following components:

- The Proposed Rule would prohibit incentive-based compensation arrangements at a covered financial institution that encourage executive officers, employees, directors, or principal shareholders ("covered persons") to expose the institution to inappropriate risks by providing the covered person excessive compensation. As described further below, consistent with the directive of section 956, the Agencies propose to use standards comparable to those developed under section 39 of the FDIA for purposes of determining whether incentive-based compensation is "excessive" in a particular case.
- The Proposed Rule would prohibit a covered financial institution from establishing or maintaining any incentive-based compensation arrangements for covered persons that encourage inappropriate risks by the covered financial institution that could lead to material financial loss. The Agencies propose to adopt standards for determining whether an incentive-based compensation arrangement may encourage inappropriate risk-taking that are consistent with the key principles established for incentive compensation in the Interagency Guidance on Sound Incentive Compensation Policies ("Banking Agency Guidance") adopted by the Federal banking agencies.[2] The Proposed Rule would also require deferral of a portion of incentive-based compensation for executive officers of larger covered financial institutions. The Proposed Rule would also

2 Guidance on Sound Incentive Compensation Policies, 75 FR 36395 (June 25, 2010), adopted by the Federal banking agencies, meaning the OCC, Board, FDIC, and OTS.

require that, at larger covered financial institutions, the board of directors or a committee of such a board identify those covered persons (other than executive officers) that have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital, or overall risk tolerance. The Proposed Rule would require that the board of directors, or a committee thereof, of the institution approve the incentive-based compensation arrangement for such individuals, and maintain documentation of such approval. The term "larger covered financial institution" for the Federal banking agencies and the SEC means those covered financial institutions with total consolidated assets of $50 billion or more. For the NCUA, all credit unions with total consolidated assets of $10 billion or more are larger covered financial institutions. For the FHFA, all Federal Home Loan Banks with total consolidated assets of $1 billion or more are larger covered financial institutions.

- In connection with these restrictions, the Proposed Rule would require covered financial institutions to maintain policies and procedures appropriate to their size, complexity, and use of incentive-based compensation to help ensure compliance with these requirements and prohibitions.
- The Proposed Rule also would require covered financial institutions to provide certain information to their appropriate Federal regulator(s) concerning their incentive-based compensation arrangements for covered persons.

The Proposed Rule would supplement existing rules and guidance adopted by the Agencies regarding compensation and incentive-based compensation.[3] These include the Banking Agency Guidance, the Standards for Safety and Soundness adopted by the Federal banking agencies,[4] the compensation-related disclosure requirements adopted by the SEC for public companies,[5] the rules and guidance adopted by the FHFA for regulatory oversight of the executive compensation practices of its regulated entities[6] and the compensation rules adopted by the NCUA for institutions under its supervision.[7] Each Agency may issue supplemental guidance specific to their regulated entities, including guidance as necessary to clarify the regulatory requirements proposed in this rulemaking. Covered financial institutions supervised by the Federal banking agencies should continue to consult the Banking Agency Guidance for additional information on how to balance risk and financial rewards.

The Agencies propose to make the terms of the Proposed Rule, if adopted, effective six months after publication of the final rule in the Federal Register, with annual

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3 See, e.g., Banking Agency Guidance, supra note 2.

4 60 FR 35674 (July 10, 1995), as amended at 61 FR 43948 (Aug. 27, 1996).

5 See, e.g., Item 402(s) of Regulation S-K, 17 CFR 229.402(s), adopted in Securities Act Release No. 9089 (Dec. 16, 2009), 74 FR 68334 (Dec. 23, 2009).

6 12 CFR 1770.1 (b) (1) requires the FHFA Director to prohibit the excessive compensation of executive officers. Section 1770.4 provides specific details as to the categories of information that are required to be submitted to the FHFA pertaining to the prohibition of excessive compensation (Sept. 12, 2001). FHFA's examination guidance (PG-06-002), "Examination for Compensation Practices," sets forth the disclosure requirements pertaining to the compensation and benefits programs of Fannie Mae and Freddie Mac (together, the Enterprises) (Nov. 8, 2006). In carrying out its corporate governance requirements, the FHFA is guided by the provisions set forth in 12 CFR 1710.13. FHFA's Advisory Bulletin (2009-AB-02), "Principles for Executive Compensation at the Federal Home Loan Banks and the Office of Finance," provides guidance to the Home Loan Banks on reporting requirements (Oct. 27, 2009). FHFA's proposed rule on executive compensation, 74 FR 26989 (June 5, 2009), includes incentive compensation in its prohibition on excessive compensation. For the FHFA, the regulated entities are, collectively: the Enterprises, the Federal Home Loan Banks, and the Office of Finance.

7 See, e.g., 12 U.S.C. 1761a; 12 CFR 701.2 & 12 CFR 701 App. A, Art. VII. §8; 12 CFR 701.21(c)(8)(i); 12 CFR 701.23(g) (1); 12 CFR 701.33; 12 CFR 702.203 & 702.204; 12 CFR 703.17; 12 CFR 704.19 & 704.20; 12 CFR part 708a; 12 CFR 712.8; 12 CFR 721.7; 12 CFR part 750; and NCUA Examiners Guide Ch. 7 at http://www.ncua.gov/GenInfo/GuidesManuals/examiners_guide/chapters/Chapter07.pdf;

reports due within 90 days of the end of each covered financial institution's fiscal year. The Agencies request specific comment on whether these dates will provide sufficient time for covered financial institutions to comply with the rule and, if not, why. Commenters are also asked to address whether the Agencies should designate different compliance dates for different types of covered financial institutions, or consider designating different compliance dates for different parts of the Proposed Rule (e.g., disclosure, prohibition, and policies and procedures).

A detailed description of the Proposed Rule with a request for comments is set forth below. Although this is a joint-interagency rulemaking, each Agency will codify its version of the rule in its specified portion of the Code of Federal Regulations in order to accommodate differences between regulated entities as well as other applicable statutory and regulatory requirements. Any significant differences between the Proposed Rules issued by individual agencies are noted below.[8]

III. SECTION-BY-SECTION DESCRIPTION OF THE PROPOSED RULE

§___.1 Authority. Section ___.1 provides that this rule is issued pursuant to section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L No. 111-203). Certain Agencies also have listed their general rulemaking authority in their respective authority citations.

§___.2 Scope and Purpose. Section ___.2 provides that this rule applies to a covered financial institution that has total consolidated assets of $1 billion or more that offers incentive-based compensation arrangements to covered persons. This section also notes

[8] Since the Agencies' proposed rules use consistent section numbering, relevant sections are cited, for example, as "§ ___.1."

that this rule would in no way limit the authority of any Agency under other provisions of applicable law and regulations.

§___.3 Definitions. Section ___.3 defines the various terms used in the Proposed Rule. If a term is defined in section 956 of the Dodd-Frank Act, the Proposed Rule generally incorporates that definition.[9]

Compensation. The Proposed Rule defines "compensation" to mean all direct and indirect payments, fees or benefits, both cash and non-cash, awarded to, granted to, or earned by or for the benefit of, any covered person in exchange for services rendered to the covered financial institution, including, but not limited to, payments or benefits pursuant to an employment contract, compensation or benefit agreement, fee arrangement, perquisite, stock option plan, postemployment benefit, or other compensatory arrangement. For credit unions, the definition of compensation specifically excludes reimbursement for reasonable and proper costs incurred by covered persons in carrying out official credit union business; provision of reasonable health, accident and related types of personal insurance protection; and indemnification. This is consistent with NCUA's regulations at 12 CFR 701.33. The Agencies seek comment on this proposed definition.

Covered Financial Institution. As noted above, only "covered financial institutions" that have total consolidated assets of $1 billion or more would be subject to the Proposed Rule. Under the Proposed Rule, a "covered financial institution" would include:

- In the case of the OCC, a national bank and Federal branch and agency of a foreign bank;

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[9] These definitions are proposed for purposes of administering Section 956 and are not intended to affect the interpretation or construction of the same or similar terms for purposes of any other statute or regulation administered by the Agencies.

- In the case of the Board, a state member bank; a bank holding company; a state-licensed uninsured branch or agency of a foreign bank; and the U.S. operations of a foreign bank with more than $1 billion of U.S. assets that is treated as a bank holding company pursuant to section 8(a) of the International Banking Act of 1978 (12 U.S.C. 3106(a)). A covered financial institution includes the subsidiaries of the institution;
- In the case of the FDIC, a state nonmember bank and an insured U.S. branch of a foreign bank;
- In the case of the OTS, a savings association as defined in 12 U.S.C. 1813(b) and a savings and loan holding company as defined in 12 U.S.C. 1467a(a). (A covered financial institution also includes an operating subsidiary of a federal savings association as defined in 12 CFR 559.2.) The Board, OCC, and FDIC will assume supervisory and rulemaking responsibility for these entities on the transfer date provided in Title III of the Dodd-Frank Act. These agencies expect to adopt, or incorporate, as appropriate, any final rule adopted by OTS as part of this rulemaking for relevant covered financial institutions that come under their respective supervisory authority after the transfer date;
- In the case of the NCUA, a credit union, as described in section 19(b)(1)(A)(iv) of the Federal Reserve Act, meaning an insured credit union as defined under 12 U.S.C. 1752(7) or credit union eligible to make application to become an insured credit union under 12 U.S.C. 1781. Instead of the term "covered financial institution", the NCUA uses the term "credit union" throughout its proposed rule;
- In the case of the SEC, a broker-dealer registered under section 15 of the

Securities Exchange Act of 1934, 15 U.S.C. 78o; and an investment adviser, as such term is defined in section 202(a)(11) of the Investment Advisers Act of 1940, 15 U.S.C. 80b-2(a)(11);[10]

- The FHFA, because it proposes to extend the requirements of the rule to the Federal Home Loan Bank System's Office of Finance,[11] which is not a financial institution, is not proposing to use the term "covered financial institution," but rather the term "covered entity," defined to mean Fannie Mae, Freddie Mac, the Federal Home Loan Banks, and the Office of Finance.

As indicated in the above listing, the Agencies propose to expand the definition of a covered financial institution beyond those specifically identified in section 956, as authorized by section 956(e)(2)(G) of the Dodd-Frank Act. Consistent with the principle of national treatment and equality of competitive opportunity, the Agencies propose to include as covered financial institutions the uninsured branches and agencies of a foreign bank, as well as the other U.S. operations of foreign banking organizations that are treated as bank holding companies pursuant to section 8(a) of the International Banking Act of 1978. These offices and operations currently are subject to the Banking Agency Guidance, and are subject to section 8 of the FDIA, which prohibits institutions from engaging in unsafe or unsound practices to the same extent as insured depository

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10 By its terms, the definition of "covered financial institution" in section 956 includes any firm that meets the definition of "investment adviser" under the Investment Advisers Act of 1940 ("Investment Advisers Act"), regardless of whether the firm is registered as an investment adviser under that Act. Banks and bank holding companies are generally excluded from the definition of "investment adviser" under section 202(a)(11) of the Investment Advisers Act.

11 The Office of Finance is a joint agency of the twelve Federal Home Loan Banks and is described and regulated in the FHFA's rules at 12 C.F.R. part 1273.

institutions and bank holding companies.[12]

The Agencies also propose including the Federal Home Loan Banks because they pose similar risks and should be subject to the same regulatory regime. FHFA also proposes to subject the Office of Finance to the Proposed Rule, using authority other than section 956.[13]

Commenters are specifically asked to address whether there are there other types of financial institutions, such as a credit union service organization ("CUSO"), that the Agencies should treat as a covered financial institution to better promote the purpose of section 956 and competitive equity. Currently no CUSOs wholly owned by a federally insured credit union have total consolidated assets of $1 billion or more.

Covered Person. Only incentive-based compensation paid to "covered persons" would be subject to the requirements of this Proposed Rule. A "covered person" would be any executive officer, employee, director, or principal shareholder of a covered financial institution. No specific categories of employees are excluded from the scope of the Proposed Rule, although it is the underlying purpose of this rulemaking to address those incentive-based compensation arrangements for covered persons or groups of covered persons that encourage inappropriate risk because they provide excessive compensation or pose a risk of material financial loss to a covered financial institution.

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12 See 12 U.S.C. 1813(c)(3) and 1818(b)(4).

13 The Office of Finance is an agent of the Federal Home Loan Banks in issuing the hundreds of billions of dollars' worth of Federal Home Loan Bank System obligations that are outstanding at any time. It is not a financial institution, but because of its critical role in the mortgage finance system, it is proposed to be made subject to the provisions of the Proposed Rule that apply to financial institutions with assets of over $50 billion. Because it is not a financial institution and hence not within the scope of section 956, FHFA bases its authority over the Office of Finance for this purpose not on section 956 but on the Federal Housing Enterprises Financial Safety and Soundness Act, which in section 1311(b)(2) (12 U.S.C. 4511(b)(2)) grants FHFA general regulatory authority over the Office of Finance.

Accordingly, as will be discussed later in this **Supplementary Information** section, certain prohibitions in the Proposed Rule apply only to a subset of covered persons. As a result, the proposal contains separate definitions of director, executive officer, and principal shareholder. For federal credit unions, only one director, if any, may be considered a covered person since, under the Federal Credit Union Act section 112 (12 U.S.C. 1761a) and NCUA's regulations at 12 CFR 701.33, only one director may be compensated as an officer of the board.

Director and Board of Directors. The Proposed Rule defines "director" of a covered financial institution as a member of the board of directors of the covered financial institution or of a board or committee performing a similar function to a board of directors. For NCUA's proposed rule, the director is always a member of the credit union's board of directors so the definition is omitted. The Proposed Rule also defines "board of directors" as the governing body of any covered financial institution performing functions similar to a board of directors. For a foreign banking organization, "board of directors" refers to the relevant senior management or oversight body for the firm's U.S. branch, agency or operations, consistent with the foreign banking organization's overall corporate and management structure. The Agencies seek comment on these proposed definitions.

Executive Officer. As discussed in more detail later in this Supplementary Information, the Proposed Rule would apply certain restrictions to the incentive-based compensation of "executive officers" of larger covered financial institutions.[14] The

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[14] As discussed previously, the term "larger covered financial institution" for the Federal banking agencies and the SEC means those covered financial institutions with total consolidated assets of $50 billion or more. For the NCUA, all credit unions with total consolidated assets of $10 billion or more are larger covered financial institutions. For the FHFA, Fannie Mae, Freddie Mac, and all of the Federal Home

Proposed Rule defines "executive officer" of a covered financial institution as a person who holds the title or performs the function (regardless of title, salary or compensation) of one or more of the following positions: president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief risk officer, or head of a major business line.[15]

- The Agencies seek comment on whether the types of positions identified in this proposed definition are appropriate, whether additional positions should be included, or if certain positions should be removed.
- Should the Agencies define "head of a major business line?"

Incentive-based Compensation. Consistent with section 956 of the Dodd-Frank Act, the Proposed Rule would apply only to incentive-based compensation arrangements. The Proposed Rule defines "incentive-based compensation" to mean any variable compensation that serves as an incentive for performance. The definition is broad and principles-based to address the objectives of section 956 in a manner that provides for flexibility as forms of compensation evolve. The form of payment, whether it is cash, an equity award, or other property, does not affect whether compensation meets the definition of "incentive-based compensation."

Loan Banks with total consolidated assets of $1 billion or more are larger covered financial institutions. In addition, the FHFA proposes to make the same requirements applicable to the Office of Finance.

15 For the FHFA, the Safety and Soundness Act of 1992, as reflected in 12 CFR 1770.3 (g)-(1), defines the term Executive Officer to mean, for Fannie Mae and Freddie Mac: the Chairman of the Board of Directors, chief executive officer, chief financial officer, chief operating officer, president, vice chairman, any executive vice president, and any individual who performs functions similar to such positions whether or not the individual has an official title; and any senior vice president or other individual with similar responsibilities, without regard to title: (A) who is in charge of a principal business unit, division or function, or (B) who reports directly to the chairman of the board of directors, vice chairman, president or chief operating officer. The Proposed Rule adopts a modified version of the definitions for Fannie Mae and Freddie Mac, and a definition for the Federal Home Loan Banks and for the Office of Finance that the FHFA has determined is appropriate for them.

There are types of compensation that would not fall within the scope of this definition. Generally, compensation that is awarded solely for, and the payment of which is solely tied to, continued employment (e.g., salary) would not be considered incentive-based compensation. Similarly, a compensation arrangement that provides rewards solely for activities or behaviors that do not involve risk-taking (for example, payments solely for achieving or maintaining a professional certification or higher level of educational achievement) would not be considered incentive-based compensation under the proposal. In addition, the Agencies do not envision that this definition would include compensation arrangements that are determined based solely on the covered person's level of fixed compensation and do not vary based on one or more performance metrics (e.g., employer contributions to a 401(k) retirement savings plan computed based on a fixed percentage of an employee's salary). The proposed definition also would not include dividends paid and appreciation realized on stock or other equity instruments that are owned outright by a covered person. However, stock or other equity instruments awarded to a covered person under a contract, arrangement, plan, or benefit would not be considered owned outright while subject to any vesting or deferral arrangement (irrespective of whether such deferral is mandatory).

The Agencies request comment generally on this proposed definition. Comment is also requested on the following questions:

- Is the definition of incentive-based compensation sufficiently broad to include all types of compensation that should be covered under the rule?
- Are there any particular forms of compensation that should be specifically designated as incentive-based compensation?

- Are there any other forms of compensation that the Agencies should clarify are not incentive-based compensation?

Principal Shareholder. Under the Proposed Rule, a "principal shareholder" means an individual that directly or indirectly, or acting through or in concert with one or more persons, owns, controls, or has the power to vote 10 percent or more of any class of voting securities of a covered financial institution.[16] The Agencies request comment on this proposed definition. The NCUA's proposed rule does not include this definition since credit unions are not-for-profit financial cooperatives with member owners.

Total Consolidated Assets. As provided in section 956, the Proposed Rule would apply to all covered financial institutions that have total consolidated assets of $1 billion or more. Additional requirements would apply to certain larger covered financial institutions. With the exception of the FHFA, the Agencies have specified how total consolidated assets should be calculated in their agency specific rule text.

- OCC: Total consolidated assets means (i) for a national bank, calculating the average of the total assets reported in the bank's four most recent Consolidated Reports of Condition and Income ("Call Report") and (ii) for a Federal branch and agency, calculating the average of the total assets reported in the Federal branch or agency's four most recent Reports of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks - FFIEC 002.
- Board: For a state member bank, total consolidated assets as determined based on the average of the bank's four most recent Consolidated Reports of Condition and Income ("Call Report"); for a bank holding company, total consolidated assets as

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16 The 10 percent threshold used in the definition of "principal shareholder" is also used in a number of bank regulatory contexts. See e.g., 12 CFR 215.2(m), 12 CFR 225.2(n)(2), 12 CFR 225.41(c)(2).

determined based on the average of the company's four most recent Consolidated Financial Statements for Bank Holding Companies ("FR Y-9C"); for a state-licensed uninsured branch or agency of a foreign bank, total consolidated assets as determined based on the average of the branch or agency's four most recent Reports of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks - FFIEC 002; and for the U.S. operations of a foreign bank, total consolidated U.S. assets as determined by the Board.

- FDIC: For state nonmember banks, asset size would be determined by calculating the average of the total assets reported in the institution's four most recent Call Reports. For insured U.S. branches of foreign banks, asset size will be determined by calculating the average of the total assets reported in the branch's four most recent Reports of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks.
- OTS: For covered financial institutions regulated by the OTS, asset size will be determined by calculating the average of total assets reported in the institution's four most recent Thrift Financial Reports.
- NCUA: For credit unions, asset size will be determined by calculating the average of the total assets reported in the credit union's four most recent 5300 Call Reports.
- SEC: For brokers or dealers registered with the SEC, asset size would be determined by the total consolidated assets reported in the firm's most recent year-end audited Consolidated Statement of Financial Condition filed pursuant to Rule 17a-5 under the Securities Exchange Act of 1934. For investment advisers,

asset size would be determined by the adviser's total assets shown on the balance sheet for the adviser's most recent fiscal year end. The proposed method of calculation for investment advisers is consistent with the SEC's recent proposal that each investment adviser filing Form ADV Part 1A indicate whether the adviser had $1 billion or more in "assets," defined as the total assets shown on the balance sheet for the adviser's most recent fiscal year end.[17] In connection with that proposal, the SEC requested comment on the reporting requirement and the proposed method that advisers would use to determine the amount of their assets (i.e., total assets as shown on the adviser's balance sheet). Commenters are asked to provide additional comments on the proposed method of determining asset size for investment advisers, and specifically to address whether the determination of total assets should be further tailored for certain types of advisers, such as advisers to hedge funds or private equity funds, and if so, why and in what manner.

- FHFA: The FHFA is not including a definition of total consolidated assets in its proposed rule because it is proposing to make all requirements of the rule applicable to all the entities it regulates without regard to asset size.[18]

The Agencies believe that by generally establishing a rolling average for asset size (with the exception of the SEC and the FHFA), the frequency that an institution may fall in or out of covered financial institution status would be minimized. If a covered

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[17] See Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Release No. 3110, nn. 194-196 and related text (Nov. 19, 2010) 75 FR 77052 (Dec. 10, 2010).

[18] Fannie Mae, Freddie Mac, and the Federal Home Loan Banks are all far larger than the $1 billion asset threshold in section 956, while the FHFA is basing its regulatory authority over the Office of Finance on a different statute. And, for policy reasons, the FHFA is proposing not to distinguish "larger" entities from others for purposes of this rule.

financial institution has fewer than four reports, the institution must average total assets from its existing reports for purposes of determining total consolidated assets. If a covered financial institution has a mix of two or more different types of reports covering the relevant period, those should be averaged for purposes of determining asset size (e.g., an institution with two Call Reports and two Thrift Financial Reports as its four most recent reports would have its total assets from all four reports averaged).

Should all of the Agencies use a uniform method to determine whether an institution has $1 billion or more in assets? If so, what would commenters suggest as such a uniform method? If different calculations are required for each type of institution, should any of the Agencies define total consolidated assets differently than the proposed calculations described above?

§ ___.4 Required Reports. Section 956(a)(1) of the Dodd-Frank Act requires that a covered financial institution submit an annual report to its appropriate Federal regulator disclosing the structure of its incentive-based compensation arrangements that is sufficient to determine whether the incentive-based compensation structure provides covered persons with excessive compensation, fees, or benefits, or could lead to material financial loss to the covered financial institution. In order to fulfill this requirement, the Proposed Rule would establish the general rule that a covered financial institution must submit a report annually to its appropriate regulator or supervisor in a format specified by its appropriate Federal regulator that describes the structure of the covered financial institution's incentive-based compensation arrangements for covered persons. The report must contain:

(1) A clear narrative description of the components of the covered financial institution's incentive-based compensation arrangements applicable to covered persons and specifying the types of covered persons to which they apply;

(2) A succinct description of the covered financial institution's policies and procedures governing its incentive-based compensation arrangements for covered persons;

(3) For larger covered financial institutions, a succinct description of any specific incentive compensation policies and procedures for the institution's executive officers, and other covered persons who the board, or a committee thereof determines under § __.5(b)(3)(ii) of the Proposed Rule individually have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital, or overall risk tolerance;

(4) Any material changes to the covered financial institution's incentive-based compensation arrangements and policies and procedures made since the covered financial institution's last report was submitted; and

(5) The specific reasons why the covered financial institution believes the structure of its incentive-based compensation plan does not encourage inappropriate risks by the covered financial institution by providing covered persons with excessive compensation or incentive-based compensation that could lead to material financial loss to the covered financial institution.

In developing the proposed reporting provisions, the Agencies have taken into account that substantially all the covered financial institutions are already supervised and/or subject to examination by one or more of the Agencies. Accordingly, in the

Proposed Rule, the Agencies have tailored the annual reporting requirement to the types of information that would most efficiently assist the relevant Agency in determining whether there are any areas of potential concern with respect to the structure of the covered financial institution's incentive-based compensation arrangements. Generally, each Agency has reporting, examination and enforcement authority for substantially all of the covered financial institutions under its respective jurisdiction that the Agency may use if the information provided under section 956 were to indicate that the structure of a covered financial institution's incentive-based compensation arrangements may provide excessive compensation or encourage inappropriate risk-taking.[19] In this way, the Proposed Rule seeks to achieve the objective of section 956 in a manner that limits unnecessary reporting burden on covered financial institutions and leverages the existing supervisory framework for institutions.

The Agencies note that they have intentionally chosen phrases like "clear narrative description" and "succinct description" to describe the disclosures being sought. The Agencies also note that the use of the word "specific" in the Proposed Rule is designed to elicit statements that are direct and meaningful explanations of why a covered financial institution believes its incentive-based compensation plan properly addresses the "excessive compensation" and "material financial loss" components of section 956. These provisions are designed to help ensure that covered financial institutions will provide the Agencies with a streamlined set of materials that will help the Agencies promptly and effectively identify and address any areas of concern, rather than with voluminous materials that may obfuscate the actual structure and likely effects of an

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[19] NCUA would likely consult with the appropriate state regulator in cases involving a state-chartered credit union.

institution's incentive-based compensation arrangements. Further, in light of the nature of the information that will be provided to the Agencies under §_.4 of the Proposed Rule, and the purposes for which the Agencies are requiring the information, the Agencies generally will maintain the confidentiality of the information submitted to the Agencies, and the information will be nonpublic, to the extent permitted by law.[20] The nature of the reported information likely will be sensitive for a variety of reasons, including competitive reasons.

The volume and detail of information provided annually by a covered financial institution should be commensurate with the size and complexity of the institution, as well as the scope and nature of its incentive-based compensation arrangements. As such, the Agencies expect that the volume and detail of information provided by a large, complex institution that uses incentive-based arrangements to a significant degree would be substantially greater than that submitted by a smaller institution that has only a few incentive-based compensation arrangements or arrangements that affect only a limited number of covered persons.

The Agencies request comment on all aspects of the reporting provisions in the Proposed Rule. Specifically, the Agencies request comment on the following:

- Does the Proposed Rule fulfill the requirement to obtain meaningful and useful descriptions of incentive-based compensation arrangements for supervisory and compliance purposes?

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20 The Freedom of Information Act ("FOIA") provides at least two pertinent exemptions under which the Agencies have authority to withhold certain information. FOIA Exemption 4 provides an exemption for "trade secrets and commercial or financial information obtained from a person and privileged or confidential." 5 U.S.C. 552(b)(4). FOIA Exemption 8 provides an exemption for matters that are "contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions." 5 U.S.C. 552(b)(8).

- Does the Proposed Rule impose a reasonable burden and minimize the potential for voluminous boilerplate disclosure?
- Is the language in the Proposed Rule sufficiently clear in describing the kinds of information the Agencies intend to solicit from covered financial institutions?
- Are there simpler and less burdensome methods of reporting to the Agencies that would still be sufficiently robust to help the Agencies assess whether the institution's compensation arrangements appropriately balance risk and financial rewards? For example, would setting up an electronic means of filing the required disclosure lessen the burden on covered financial institutions, and are there specific factors the Agencies should consider in developing such a disclosure mechanism?
- Are there any additional types of information that the Agencies should solicit in order to more accurately assess whether incentive-based compensation arrangements are consistent with the objectives of section 956?
- Should the Agencies consider modifying the Proposed Rule to require covered financial institutions to update their incentive-based compensation disclosure -- between annual disclosure cycles -- if any material changes to their respective incentive-based compensation plans occur?

§ ___.5 Prohibitions. Section ___.5 of the Proposed Rule would implement section 956(b) of the Dodd-Frank Act by prohibiting a covered financial institution from having incentive-based compensation arrangements that may encourage inappropriate risks (a) by providing excessive compensation or (b) that could lead to material financial loss to the covered financial institution. Consistent with section 956(c), the Proposed Rule also would establish standards for determining whether an incentive-based compensation arrangement violates these prohibitions.

Excessive Compensation. The Proposed Rule would establish a general rule that a covered financial institution must not establish or maintain any type of incentive-based compensation arrangement, or any feature of any such arrangement, that encourages inappropriate risks by the covered financial institution by providing a covered person with excessive compensation. As noted previously, section 956 requires the Agencies to ensure that any compensation standards established under section 956 are comparable to those established under section 39 of the FDIA. In light of this directive, the Proposed Rule includes standards for determining whether an incentive-based compensation arrangement provides excessive compensation that are comparable to, and based on, the standards established under section 39 of the FDIA. Specifically, under the Proposed Rule, incentive-based compensation for a covered person would be considered excessive when amounts paid are unreasonable or disproportionate to, among other things, the amount, nature, quality, and scope of services performed by the covered person. In making such a determination, the Agencies will consider:

(1) The combined value of all cash and non-cash benefits provided to the covered person;

(2) The compensation history of the covered person and other individuals with comparable expertise at the covered financial institution;

(3) The financial condition of the covered financial institution;

(4) Comparable compensation practices at comparable institutions, based upon such factors as asset size, geographic location, and the complexity of the institution's operations and assets;

(5) For postemployment benefits, the projected total cost and benefit to the covered financial institution;

(6) Any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the covered financial institution; and

(7) Any other factors the Agency determines to be relevant.

The Agencies request comment on these standards, including comment on the appropriate factors to consider when evaluating comparable compensation practices at comparable institutions. Should additional factors be included, such as the nature of the operations at the comparable institutions?

Inappropriate Risks that May Lead to Material Financial Loss. Section 956(b)(2) of the Act requires the Agencies to adopt regulations or guidelines that prohibit any type of incentive-based payment arrangement, or any feature of any such arrangement, that the Agencies determine encourages inappropriate risks by a covered financial institution that could lead to material financial loss to the covered institution. Section 39 of the FDIA does not include standards for determining whether compensation arrangements may encourage inappropriate risks that could lead to material financial loss. Accordingly the Agencies have considered the language and purpose of section 956, existing supervisory guidance that addresses incentive-based compensation arrangements that may encourage excessive risk-taking,[21] the Principles for Sound Compensation Practices and the related Implementation Standards adopted by the Financial Stability Board,[22] and other relevant material in considering how to implement this aspect of section 956.

As an initial matter, the Agencies note that section 956 is focused on incentive-based compensation arrangements that could lead to material financial loss to a covered financial institution. Accordingly, this prohibition would apply only to those incentive-based compensation arrangements for individual covered persons, or groups of covered persons, whose activities may expose the covered financial institution to material financial loss. Such covered persons include:

- Executive officers and other covered persons who are responsible for oversight of the covered financial institution's firm-wide activities or material business lines;
- Other individual covered persons, including non-executive employees, whose activities may expose the covered financial institution to material financial loss (e.g., traders with large position limits relative to the covered financial institution's overall risk tolerance); and
- Groups of covered persons who are subject to the same or similar incentive-based compensation arrangements and who, in the aggregate, could expose the covered financial institution to material financial loss, even if no individual covered person in the group could expose the covered financial institution to material financial loss (e.g., loan officers who, as a group, originate loans that account for a material amount of the covered financial institution's credit risk).

21 See, e.g., Banking Agency Guidance.

22 Financial Stability Board, FSF Principles for Sound Compensation Practices, Basel, Switzerland (April 2009); Financial Stability Board, FSB Principles for Sound Compensation Practices: Implementation Standards, Basel. Switzerland (September 2009).

To implement section 956(b)(2) of the Act, § ___.5(b)(1) of the Proposed Rule would prohibit a covered financial institution from establishing or maintaining any type of incentive compensation arrangement, or any feature of any such arrangement, for these covered persons or groups of covered persons, that could lead to material financial loss to the covered financial institution. Section ___.5(b)(2) of the Proposed Rule provides that an incentive-based compensation arrangement established or maintained by a covered financial institution for one or more covered persons does not comply with § ___.5(b)(1) unless it:

- Balances risk and financial rewards, for example by using deferral of payments, risk adjustment of awards, reduced sensitivity to short-term performance, or longer performance periods;
- Is compatible with effective controls and risk management; and
- Is supported by strong corporate governance.

These three standards are consistent with the principles for sound compensation practices in the Banking Agency Guidance.

The following describes these proposed standards in greater detail. In order to help ensure that the incentive-based compensation arrangements of covered financial institutions are consistent with their standards, § ___.6 of the Proposed Rule would require that covered financial institutions establish and maintain policies and procedures related to these standards.

<u>Balance of Risk and Financial Rewards</u>

Incentive-based compensation arrangements typically attempt to encourage actions that result in greater revenue or profit for the covered financial institution.

However, short-run revenue or profit can often diverge sharply from actual long-run profit because risk outcomes may become clear only over time. Activities that carry higher risk typically yield higher short-term revenue, and a covered person who is given incentives to increase short-term revenue or profit, without regard to risk, will naturally be attracted to opportunities to expose the institution to more risk.[23]

Accordingly, to be consistent with section 956, incentive-based compensation arrangements at a covered financial institution should balance risk and financial rewards in a manner that does not provide covered persons with incentives to take inappropriate risks that could lead to material financial loss at the covered financial institution. The Agencies would deem an incentive-based compensation arrangement to be balanced when the amounts paid to a covered person appropriately take into account the risks, as well as the financial benefits, from the covered person's activities and the impact of those activities on the covered financial institution.

In assessing whether incentive-based compensation arrangements are balanced, the Agencies will consider the full range of risks associated with a covered person's activities, as well as the time horizon over which those risks may be realized. The activities of a covered person may create a wide range of risks for a covered financial institution, including credit, market, liquidity, operational, legal, compliance, and reputational risks. Some of these risks may be realized in the short term, while others may become apparent only over the long term.

The Proposed Rule identifies four methods that currently are often used to make compensation more sensitive to risk. These methods are:

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[23] See Banking Agency Guidance at 36407.

Risk Adjustment of Awards: Under this method of making a covered person's incentive-based compensation appropriately risk-sensitive, the amount of the person's incentive-based compensation award is adjusted based on measures that take into account the risk the covered person's activities pose to the covered financial institution. Such measures may be quantitative, or the size of a risk adjustment may be set based on managerial judgment, subject to appropriate oversight.

Deferral of Payment: Under this method, the actual payout of an award to a covered person is delayed significantly beyond the end of the performance period, and the amounts paid are adjusted for actual losses to the covered financial institution or other aspects of performance that become clear only during the deferral period. Deferred payouts may be altered according to risk outcomes either formulaically or based on managerial judgment, though extensive use of judgment might make it more difficult to execute deferral arrangements in a sufficiently predictable fashion to influence the risk-taking behavior of a covered person. To be most effective in ensuring balance, the deferral period should be sufficiently long to allow for the realization of a substantial portion of the risks from the covered person's activities, and the measures of loss should be clearly explained to covered persons and closely tied to their activities during the relevant performance period.

Longer Performance Periods: Under this method of making incentive-based compensation risk sensitive, the time period covered by the performance measures used in determining a covered person's award is extended (for example, from one year to two years). Longer performance periods and deferral of payment are related in that both methods allow awards or payments to be made after some or all risk outcomes associated with a covered person's activities are realized or better known.

Reduced Sensitivity to Short-Term Performance: A covered financial institution using this method reduces the rate at which awards increase as a covered person achieves higher levels of the relevant performance measure(s) used in the person's incentive-based compensation arrangement. Rather than offsetting risk-taking incentives associated with the use of short-term performance measures, this method reduces the magnitude of such incentives.

The Agencies recognize that these methods for achieving balance are not exclusive, and additional methods or variations of these approaches may exist or be developed.[24] Methods and practices for making compensation sensitive to risk-taking are likely to evolve during the next few years. Moreover, each method has its own advantages and disadvantages that may differ depending upon the situation in which they are used. For example, where reliable risk measures exist, risk adjustment of awards may be more effective than deferral of payment in reducing incentives for inappropriate risk-taking. This is because risk adjustment potentially can take account of the full range and time horizon of risks, rather than just those risk outcomes that occur or become evident during the deferral period. On the other hand, deferral of payment may be more effective than risk adjustment in mitigating incentives to take hard-to-measure risks (such as the risks of new activities or products, or certain risks such as reputational or operational risk that may be difficult to measure with respect to particular activities), especially if such risks are likely to be realized during the deferral period. In some cases, two or more

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[24] See Banking Agency Guidance at 36407.

methods may be needed in combination for an incentive-based compensation arrangement to be balanced. The greater the potential incentives that an arrangement creates for a covered person to increase the risks borne by the covered financial institution, the stronger the effect should be of the methods applied to achieve balance.[25]

Compatibility with Effective Controls and Risk Management

A covered financial institution's risk management processes and internal controls should reinforce and support the development and maintenance of balanced incentive-based compensation arrangements.[26] In particular, under this proposed standard, the Agencies would expect a covered financial institution to have strong controls governing its processes for designing, implementing and monitoring incentive-based compensation arrangements, and for ensuring that risk-management personnel have an appropriate role in the institution's processes for designing incentive-based compensation arrangements, monitoring their use, and assessing whether they achieve balance. Covered financial institutions should have appropriate controls to ensure that their processes for achieving balanced compensation arrangements are followed and to maintain the integrity of their risk management and other functions. Such controls are important because covered persons may seek to evade or weaken an institution's processes to achieve balanced incentive-based compensation arrangements in order to increase their own compensation. For example, in order to increase his or her own incentive compensation, a covered person may seek to influence inappropriately the risk measures, information, or judgments used to balance the covered person's compensation. These activities can have additional damaging effects on the institution's financial health if they result in the

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[25] See Banking Agency Guidance at 36409.

[26] See Banking Agency Guidance at 36410 - 11.

weakening of the information or processes that the institution uses for other risk management, internal control, or financial purposes.[27]

Strong Corporate Governance

Strong and effective corporate governance is critical to the establishment and maintenance of sound compensation practices.[28] The board of directors of a covered financial institution, or committee thereof, should actively oversee incentive-based compensation arrangements and is ultimately responsible for ensuring that the covered financial institution's incentive compensation arrangements are appropriately balanced. Accordingly, the board of directors, or a committee thereof, should actively oversee the development and operation of a covered financial institution's incentive-based compensation systems and related control processes. For example, the board of directors, or a committee thereof, should review and approve the overall goals and purposes of the covered financial institution's incentive-based compensation system and ensure its consistency with the institution's overall risk tolerance. In addition, the board of directors, or committee thereof, should receive data and analysis to assess whether the overall design, as well as the performance, of the institution's incentive compensation arrangements are consistent with section 956.

The Agencies request comment on all aspects of § ____.5 of the Proposed Rule. The Agencies also request comment on whether there are additional factors that should be considered in evaluating whether compensation is excessive or could lead to material financial loss and whether the Proposed Rule should include additional details about each of these standards.

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27 See Banking Agency Guidance at 36411.

28 See Banking Agency Guidance at 36412.

Larger Covered Financial Institutions

Deferral arrangements required for Executive Officers

Paragraph (b)(3) of § ___.5 of the Proposed Rule would establish a deferral requirement for larger covered financial institutions (i.e., generally those with $50 billion or more in total consolidated assets).[29] At these larger covered financial institutions, at least 50 percent of the incentive-based compensation of an "executive officer" (as previously defined), would have to be deferred over a period of at least three years. The Proposed Rule also would require that deferred amounts paid be adjusted for actual losses of the covered financial institution or other measures or aspects of performance that are realized or become better known during the deferral period.

The Agencies believe that incentive-based compensation arrangements for executive officers at larger covered financial institutions are likely to be better balanced if they involve the deferral of a substantial portion of the executives' incentive compensation over a multi-year period in a way that reduces the amount received in the event of poor performance. The decisions of executive officers have a significant impact on the entire organization and often involve substantial strategic or other risks that are difficult to measure and model -- particularly at larger covered financial institutions -- and therefore difficult to address adequately by ex ante risk adjustments.

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[29] As noted above, the FHFA is proposing to adopt this requirement for all the entities it regulates – Fannie Mae, Freddie Mac, the twelve Federal Home Loan Banks, and the Office of Finance, without regard to asset size, except for covered entities in conservatorship, receivership, or bridge status. FHFA, as conservator of Fannie Mae and Freddie Mac, requires that one third of incentive pay for named executive officers be deferred over a two-year period. This deferred pay is based on corporate and individual performance. In addition, deferred pay is paid to Senior Vice Presidents and above in quarterly installments in the year following the performance year. One-half of this one-year deferral of payments is based on the Board of Directors' determination of corporate performance. As a result, more than one-half of the annual incentive-based compensation is deferred for senior executives.

Requiring deferral for executive officers is consistent with international standards[30] that establish the expectation that large interconnected firms require the deferral of a substantial portion of incentive-based compensation (identified as 40 to 60 percent of the incentive award, or more) for certain employees for a fixed period of time not less than three years and that incentives be correctly aligned with the nature of the business, its risks, and the activities of the employees in question. Because the risks of strategic and other high-level decisions of executive officers may not be apparent or become better known for many years, the Proposed Rule would require that the deferral arrangement for executive officers at these larger covered financial institutions extend for at least three years. Larger covered financial institutions tend to have more diverse business operations, which can make it more difficult to immediately recognize and assess risks for the organization as a whole. Furthermore, in enacting the Dodd-Frank Act, Congress recognized that larger organizations may pose a greater risk to the financial system by requiring the creation of enhanced prudential standards for certain bank holding companies with total consolidated assets greater than $50 billion.[31]

The Proposed Rule recognizes that requiring deferral for this discrete group of individuals at larger covered institutions, where ex ante risk adjustment measures are less likely to be effective in and of themselves, is likely to be a useful balancing tool that allows a period of time for risks not previously discerned or quantifiable to ultimately materialize, and concurrently provides for adjustment of unreleased (or "unvested") deferral payments on the basis of observed consequences and actual performance as opposed to only predicted results.

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30 See supra note 22.

31 12 U.S.C. 5635.

If a covered financial institution is required to use deferral, the Proposed Rule provides it with flexibility in administering its specific deferral program. A covered financial institution may decide to release (or allow vesting of) the full deferred amount in a lump-sum only at the conclusion of the deferral period; alternatively, the institution may release the deferred amounts (or allow vesting) in equal increments, pro rata, for each year of the deferral period. However, in no event may the release or vesting of amounts required to be deferred under § ___.5(b)(3) of the Proposed Rule be faster than a pro rata equal-annual-increments distribution. For instance, an institution required to apply a three-year deferral to a $150,000 deferral amount could release a maximum of $50,000 each year or could withhold the entire sum for the entire period and distribute it as a lump-sum at the conclusion of the three-year period. The institution could also employ an alternate distribution that is less rapid than a pro-rata equal-annual-increments schedule, such as releasing no amount after the first year, releasing a maximum of $100,000 the second year, and then $50,000 for the third year.

Specific comment is solicited on all aspects of the scope, and specific requirements, of this proposed deferral requirement. In particular, commenters are asked to address whether it is appropriate to mandate deferral for executive officers at larger covered financial institutions to promote the alignment of employees' incentives with the risk undertaken by such employees. For example, comment is solicited on whether deferral is generally an appropriate method for achieving balanced incentive compensation arrangements for each type of executive officer at these institutions or whether there are alternative or more effective ways to achieve such balance. Commenters are also asked to address the possible impact that the required minimum deferral provisions for senior executives may have on larger covered financial institutions and whether the proposed or different deferral requirements should apply to senior executives at institutions other than larger covered financial institutions. For example, would it be prudent to mandate deferred incentive-based compensation for certain types of covered financial institutions but not require such deferral for other institutions (e.g., investment advisers) based on the business, risks inherent to that business, or other relevant factors? Are there additional considerations, such as tax or accounting considerations, that may affect the ability of larger covered financial institutions to comply with the proposed deferral requirement or that the Agencies should consider in designing this provision in the rule? Comment is also sought on whether the mandatory deferral provisions of the rule should apply to a differently defined group of individuals at larger covered financial institutions, such as the institution's top 25 earners of incentive-based compensation? Commenters also are asked to address whether the three-year and 50 percent of incentive-based compensation minimums are appropriate? Should the minimum required deferral period be extended to, for example, five years?

Special Review and Approval Requirement for Other Designated Individuals

Other individuals at a larger covered financial institution, beyond the institution's executive officers may have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital, or overall risk tolerance. In order to help ensure that the incentive compensation arrangements for these individuals are appropriately balanced, and do not encourage the individual to expose the institution to risks that could pose a risk of material financial loss to the covered financial institution, the Proposed Rule would require that, at a larger covered financial institution, the board of directors, or a committee thereof, identify those covered persons (other than executive officers) that individually have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital, or overall risk tolerance.[32] The proposal notes that these covered persons may include, for example, traders with large position limits relative to the institution's overall risk tolerance and other individuals that have the authority to place at risk a substantial part of the capital of the covered financial institution. In addition, the Proposed Rule would require that the board of directors, or a committee thereof, of the institution approve the incentive-based compensation arrangement for such individuals, and maintain documentation of such approval.

Under the proposal, the board of directors, or committee thereof, of a larger covered financial institution may not approve the incentive-based compensation arrangement for an individual identified by the board of directors, or committee thereof, unless the board (or committee) determines that the arrangement, including the method of paying compensation under the arrangement, effectively balances the financial rewards to the covered person and the range and time horizon of risks associated with the covered person's activities, employing appropriate methods for ensuring risk sensitivity. The proposal recognizes that the methods used to balance the rewards and risks of the individual's activities may include deferral of payments, risk adjustment of awards, reduced sensitivity to short-term performance, or longer performance periods, or other appropriate methods. However, the board of directors, or committee thereof, must determine that the method(s) used effectively balance the financial rewards to the covered person and the range and time horizons of the risks associated with the covered person's

32 In addition to the compensation-deferral requirement described above, the FHFA proposes to apply this requirement to all of the entities it regulates without regard to asset size.

activities. In performing its duties in this regard, the board, or committee thereof, must evaluate the overall effectiveness of the balancing methods used in the identified covered person's incentive compensation arrangements in reducing incentives for inappropriate risk taking by the identified covered person, as well as the ability of the methods used to make payments sensitive to the full range of risks presented by that covered person's activities, including those risks that may be difficult to predict, measure, or model.

The Agencies request comment on these proposed additional identification, review, and approval requirements for larger covered financial institutions with respect to individuals that have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital, or overall risk tolerance. Is the proposed special treatment of these covered persons necessary or appropriate, or is their incentive compensation adequately addressed by the prohibitions applicable to all other covered persons (other than executive officers at larger covered financial institutions) under the proposal? Is it sufficient that, as under the proposal, such covered persons are not subject to mandatory deferral but instead are separately identified by the institution's board and the board is required to approve the incentive-based compensation arrangement for the covered person after ensuring it is balanced and sensitive to risk? Should further guidance be provided as to the meaning of the phrase "substantial in relation to the institution's size, capital, or overall risk tolerance"?

§ ___.6 Policies and Procedures. As noted above, the Agencies believe that the incentive-based compensation practices of covered financial institutions should be supported by policies and procedures, appropriate to the size and complexity of the covered financial institution, to foster transparency of each covered financial institution's incentive-based compensation practices and to promote compliance and accountability regarding the practices that the Agencies propose to prohibit. Accordingly, the Proposed Rule would require covered financial institutions to have policies and procedures governing the award of incentive-based compensation as a way to help ensure the full implementation of the prohibitions in the Proposed Rule.

The Agencies believe that the policies and procedures developed by each covered financial institution in this area should be appropriately tailored to balance risk and reward for an institution of its size, complexity, and business activity, as well as the scope and nature of the covered financial institution's incentive-based compensation arrangements. Therefore, the policies and procedures of smaller covered financial institutions with less complex incentive-based compensation programs would be expected to be less extensive than those of larger covered financial institutions with relatively complex programs and business activities. The Agencies note, however, that no categories of covered financial institutions using incentive-based compensation would be systematically or completely exempt from developing, maintaining, and documenting their incentive-based compensation policies and procedures.

As noted above, the prohibition on incentive-based compensation arrangements that could lead to material financial loss would affect only those arrangements for covered persons that, either individually or as a group, may expose the institution to material financial loss. Accordingly, the policies and procedures of an institution related to this prohibition should be focused on these covered persons. Depending on the facts and circumstances of the individual covered financial institution, certain jobs and classes of jobs may not have the ability to expose the organization to material financial loss and, as a result, incentive-based compensation arrangements for these covered persons within these job classes may be outside the scope of these restrictions. Examples of jobs and classes of jobs that may be unlikely to expose the institution to material risk include tellers, bookkeepers, couriers, or data processing personnel.

Paragraph (b)(1) of § ___.6 of the Proposed Rule would require that the policies and procedures, at a minimum, be designed to address the § ___.4 reporting requirements and the § ___.5 prohibitions..[33] Requiring such policies and procedures of covered financial institutions that award incentive-based compensation would promote compliance with the prohibitions in practice.

In order to help ensure that the risks inherent in a covered person's actions are appropriately captured, the Agencies believe that risk-management, risk-oversight, and internal-control personnel should be involved in all phases of the process for designing incentive-based compensation arrangements. Risk-management and risk-oversight personnel also should have responsibility for ongoing assessment of incentive-based compensation policies to help to ensure that the covered financial institution's processes remain up-to-date and effective relative to its incentive compensation practices. The ongoing involvement of such personnel in the evaluation of incentive-based compensation arrangements also helps to ensure that risks are properly understood and evaluated as such risks change over time in light of a continuously changing business environment. Accordingly, paragraph (b)(2) of § ___.6 of the Proposed Rule would make

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[33] In addition, for U.S. operations of foreign banking organizations ("FBOs"), the organization's policies, including management, review, and approval requirements for its U.S. operations, should be coordinated with the FBO's group-wide policies developed in accordance with the rules of the FBO's home country supervisor. The policies of the FBO's U.S. operations should also be consistent with the FBO's overall corporate and management structure, as well as its framework for risk-management and internal controls.

such a requirement part of the covered financial institution's policies and procedures governing incentive-based compensation.

Paragraph (b)(3) of §___.6 would require that a covered financial institution's policies and procedures provide for the monitoring by a group or person independent of the covered person, where practicable in light of the institution's size and complexity, of incentive-based compensation awards and payments, risks taken, and actual risk outcomes to determine whether incentive-based compensation payments are reduced to reflect adverse risk outcomes or high levels of risk taken. To be considered independent under the Proposed Rule, the group or person at the covered financial institution monitoring or assessing incentive-based compensation awards must have a separate reporting line to senior management from the covered person who is creating the risks so as to help ensure that the analysis of risk is unbiased. Given the dynamic nature of risk management, the Proposed Rule also provides for incentive-based compensation awards to be monitored in light of risks taken and outcomes to determine whether incentive-based payments should be modified. The Agencies contemplate that the procedures relating to the adjustment of deferred amounts would be used by covered financial institutions required to defer a portion of their incentive-based compensation under § ___.6 of this Rule to augment their compliance with the deferral obligation.

Paragraph (b)(4) of § ___.6 would require a covered financial institution to develop and maintain policies and procedures designed to ensure that the covered financial institution's board of directors, or a committee thereof, receive data and analysis from management and other sources sufficient to allow it to assess whether the overall design and performance of the firm's incentive-based compensation arrangements are consistent with section 956 of the Act. As with other provisions of the Proposed Rule, the scope and nature of the data and analysis should be appropriate to the size and complexity of the covered financial institution and its use of incentive-based compensation. The Agencies expect that the board of directors, or committee thereof, would take into consideration the firm's overall risk management policies and procedures and the requirements of section 956(b) of the Act when assessing compliance with the Act.

Paragraph (b)(5) of § ___.6 of the Proposed Rule would specify that the policies and procedures of a covered financial institution must provide that the institution maintains sufficient documentation of the institution's processes for establishing, implementing, modifying, and monitoring incentive-based compensation arrangements sufficient to enable the institution's appropriate Federal regulator to determine the covered financial institution's compliance with section 956 of the Act and the Proposed Rule. Given that the determinations to be made regarding incentive-based compensation are fact-specific, the Agencies believe that effective documentation of the covered financial institution's policies, procedures and actions related to incentive-based compensation is essential both to help promote the risk-based discipline that section 956 of the Act seeks to foster with respect to covered financial institutions and to facilitate meaningful oversight and examination. In this context, the Agencies would expect the documentation maintained by a covered financial institution under the Proposed Rule to include, but not be limited to, the following:

(1) A copy of the covered financial institution's incentive-based compensation arrangement(s) or plan(s);

(2) The names and titles of individuals covered by such arrangement(s) or plan(s);

(3) A record of the incentive-based compensation awards made under the arrangement(s) or plan(s); and

(4) Records reflecting the persons or units involved in the approval and ongoing monitoring of the arrangement(s) or plan(s).

Paragraph (b)(6) of § ___.6 of the Proposed Rule would provide that, where a covered financial institution uses deferral in connection with an incentive-based compensation arrangement, the institution's policies and procedures provide for deferral of any such payments in amounts and for periods of time appropriate to the duties and responsibilities of the covered financial institution's covered persons, the risks associated with those duties and responsibilities, and the size and complexity of the covered financial institution.[34] Further, proposed paragraph (b)(6) would require that any such deferred amounts paid be adjusted for actual losses or other measures or aspects of performance that are realized or become better known during the deferral period. The Agencies believe that risk-management personnel at the covered financial institution would play a substantial role in identifying and evaluating risks that become better known with the passage of time. The Agencies contemplate that the procedures relating to the adjustment of deferred amounts would be used by covered financial institutions required to defer a portion of their incentive-based compensation under § ___.5 of the Proposed Rule to facilitate their compliance with the deferral obligation.

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[34] The Proposed Rule would require deferral for at least three years of at least 50 percent of the incentive-based compensation for executive officers of larger covered financial institutions (generally those with $50 billion or more in total consolidated assets). Most covered financial institutions with total consolidated assets under $50 billion would be required to adopt procedures applicable to deferred compensation only when the firm elects to use deferral in its incentive-based compensation program.

Given the importance of incentive-based compensation arrangements to a covered financial institution's safety and soundness, paragraph (b)(7) of §___.6 would require the policies and procedures to subject any incentive-based compensation arrangement or component thereof to a corporate governance framework that provides for ongoing oversight by the board of directors or a committee of the board of directors. As discussed above, covered financial institutions should have strong and effective corporate governance to help ensure sound compensation practices, including active and effective oversight by the board of directors. The Agencies believe that the board of directors or a committee thereof is ultimately responsible for a covered institution's incentive-based compensation arrangements, which should appropriately balance risk and rewards. Therefore, the board or its committee should engage in regular oversight of the covered financial institution's incentive-based compensation arrangements.

The Agencies are aware that covered persons at certain covered financial institutions who have been awarded equity as part of a deferred incentive-based compensation arrangement may wish to use personal hedging strategies as a way to lock in value for equity compensation that is vested over time. The Agencies are concerned that undertaking such hedging strategies during deferral periods could diminish the alignment between risk and financial rewards that may be achieved through these types of deferral arrangements. The Agencies have not included policies and procedures regarding such personal hedging strategies in the Proposed Rule, but the Agencies are concerned that, to the extent personal hedging strategies may be widespread, such practices would serve to diminish the effectiveness of a covered financial institution's policies and procedures. Thus, the Agencies are considering whether a covered financial institution's policies and procedures should be required to specifically include limits on personal hedging strategies. To assist in the evaluation of such a provision, in addition to requesting comment on all aspects of § ___.6 of the Proposed Rule, the Agencies are requesting commenters to describe the extent to which covered financial institutions prohibit such practices among their covered persons today. Would prohibiting the use of financial derivatives, insurance contracts or other similar mechanisms to hedge against the market risk of equity-based incentive-based compensation be an effective means to help to ensure that incentive-based compensation arrangements remain aligned with the risk assumed by covered persons? Are there other factors the Agencies should take into account when considering if, or how, to address personal hedging activity by covered persons?

§ ___.7 Evasion. Section ___.7 of the Proposed Rule would prohibit a covered financial institution from evading the restrictions of the rule by doing any act or thing indirectly, or through or by any other person, that would be unlawful for the covered institution to do directly under the Proposed Rule. This anti-evasion provision is designed to prevent covered financial institutions from, for example, making substantial numbers of its covered persons independent contractors for the purpose of evading this subpart. The Agencies do not intend, however, to disrupt bona fide independent contractor relationships of covered financial institutions. Comments are invited on whether greater specificity is required in identifying possible evasion tactics, and on all aspects of § ___.7.

IV. REQUEST FOR COMMENTS

The Agencies encourage comment on any aspect of this proposal and especially on those issues specifically noted in this preamble.

Solicitation of Comments on Use of Plain Language

Section 722 of the Gramm-Leach-Bliley Act, Pub. L. 106-102, sec. 722, 113 Stat. 1338, 1471 (Nov. 12, 1999), requires the Federal banking agencies to use plain language in all proposed and final rules published after January 1, 2000. The Federal banking agencies invite your comments on how to make this proposal easier to understand. For example:

- Have we organized the material to suit your needs? If not, how could this material be better organized?
- Are the requirements in the proposed regulation clearly stated? If not, how could the regulation be more clearly stated?
- Does the proposed regulation contain language or jargon that is not clear? If so, which language requires clarification?
- Would a different format (grouping and order of sections, use of headings, paragraphing) make the regulation easier to understand? If so, what changes to the format would make the regulation easier to understand?
- What else could we do to make the regulation easier to understand?

NCUA Agency Regulatory Goal

NCUA's goal is to promulgate clear and understandable regulations that impose minimal regulatory burden. We request your comments on whether the proposed rule is understandable and minimally intrusive if implemented as proposed.

V. REGULATORY ANALYSIS:

A. Regulatory Flexibility Act

<u>**OCC:**</u> Pursuant to section 605(b) of the Regulatory Flexibility Act, 5 U.S.C. 605(b) (RFA), the regulatory flexibility analysis otherwise required under section 603 of the RFA is not required if the agency certifies that the proposed rule will not, if promulgated, have a significant economic impact on a substantial number of small entities (defined for purposes of the RFA to include banks and Federal branches and agencies with assets less than or equal to $175 million) and publishes its certification and a short, explanatory statement in the <u>Federal Register</u> along with its proposed rule.

Consistent with section 956(f) of the Dodd-Frank Act, the OCC's proposed rule only would apply to national banks and Federal branches and agencies that have total consolidated assets of $1 billion or more. The Proposed Rule would not apply to any small national banks and Federal branches and agencies, as defined by the RFA. Therefore, the OCC certifies that the Proposed Rule would not, if promulgated, have a significant economic impact on a substantial number of small entities.

<u>**Board**</u>: The Board has considered the potential impact of the Proposed Rule on small banking organizations in accordance with the Regulatory Flexibility Act (5 U.S.C. 603(b)). As discussed in the "Supplementary Information" above, section 956 of the Dodd-Frank Act (codified at 12 U.S.C. 5641) requires that the Agencies prohibit any incentive-based payment arrangement, or any feature of any such arrangement, at a covered financial institution that the Agencies determine encourages inappropriate risks by a financial institution by providing excessive compensation or that could lead to material financial loss. In addition, under the Act a covered financial institution also

must disclose to its appropriate Federal regulator the structure of its incentive-based compensation arrangements. The Board and the other Agencies have issued the Proposed Rule in response to these requirements of the Dodd-Frank Act.

The Proposed Rule would apply to "covered financial institutions" as defined in section 956 of the Dodd-Frank Act. Covered financial institutions as so defined include specifically listed types of institutions, as well as other institutions added by the Agencies acting jointly by rule. In every case, however, covered financial institutions must have at least $1 billion in total consolidated assets pursuant to section 956(f). Thus the Proposed Rule is not expected to apply to any small banking organizations (defined as banking organizations with $175 million or less in total assets). See 13 CFR 121.201.

The Proposed Rule would implement section 956(a) of the Dodd-Frank act by requiring a covered financial institution to submit a report annually to its appropriate regulator or supervisor in a format specified by its appropriate Federal regulator that describes the structure of the covered financial institution's incentive-based compensation arrangements for covered persons. The volume and detail of information provided annually by a covered financial institution should be commensurate with the size and complexity of the institution, as well as the scope and nature of its incentive-based compensation arrangements. As such, the Board expects that the volume and detail of information provided by a large, complex institution that uses incentive-based arrangements to a significant degree would be substantially greater than that submitted by a smaller institution that has only a few incentive-based compensation arrangements or arrangements that affect only a limited number of covered persons.

The Proposed Rule would implement section 956(b) of the Dodd-Frank Act by prohibiting a covered financial institution from having incentive-based compensation arrangements that may encourage inappropriate risks (i) by providing excessive compensation or (ii) that could lead to material financial loss. The Proposed Rule would establish standards for determining whether an incentive-based compensation arrangement violates these prohibitions. These standards would include deferral and other requirements for certain covered persons at covered financial institutions with total consolidated assets of more than $50 billion. Consistent with section 956(c), the standards adopted under section 956 are comparable to the compensation-related safety and soundness standards applicable to insured depository institutions under section 39 of the FDIA. The Proposed Rule also would supplement existing guidance adopted by the Board and the other Federal banking agencies regarding incentive-based compensation (i.e., the Banking Agency Guidance, as defined in the "Supplementary Information" above).

The Proposed Rule would require covered financial institutions to have policies and procedures governing the award of incentive-based compensation as a way to help ensure the full implementation of the prohibitions in the Proposed Rule. The Board believes that the policies and procedures developed by each covered financial institution in this area should be appropriately tailored to balance risk and reward for an institution of its size, complexity, and business activity, as well as the scope and nature of the covered financial institution's incentive-based compensation arrangements. Therefore, the policies and procedures of smaller covered financial institutions with less complex incentive-based compensation programs would be expected to be less extensive than those of larger covered financial institutions with relatively complex programs and business activities.

As noted above, because the Proposed Rule applies to institutions that have more than $1 billion in total consolidated assets, if adopted in final form it is not expected to apply to any small banking organizations for purposes of the Regulatory Flexibility Act. In light of the foregoing, the Board does not believe that the Proposed Rule, if adopted in final form, would have a significant economic impact on a substantial number of small entities supervised by the Board. The Board specifically seeks comment on whether the Proposed Rule would impose undue burdens on, or have unintended consequences for, small organizations and whether there are ways such potential burdens or consequences could be addressed in a manner consistent with section 956 of the Dodd-Frank Act.

FDIC: In accordance with the Regulatory Flexibility Act, 5 U.S.C. 601-612 (RFA), an agency must publish an initial regulatory flexibility analysis with its Proposed Rule, unless the agency certifies that the rule will not have a significant economic impact on a substantial number of small entities. For purposes of the RFA, small entities are defined to include banks with less than $175 million in assets.

Consistent with section 956 of the Dodd-Frank Act, the FDIC's Proposed Rule would only apply to a State nonmember bank and an insured U.S. branch of a foreign bank that has total consolidated assets of $1 billion or more and offers incentive compensation. The Proposed Rule would not apply to any small banks as defined by the RFA. Thus, the FDIC certifies that the Proposed Rule, if promulgated, would not have a significant economic impact on a substantial number of small entities.

OTS: Pursuant to section 605(b) of the Regulatory Flexibility Act, 5 U.S.C. 605(b) (RFA), the regulatory flexibility analysis otherwise required under section 603 of the RFA is not required if the agency certifies that the proposed rule, if promulgated, will not have a significant economic impact on a substantial number of small entities and publishes its certification and a short, explanatory statement in the Federal Register along with its proposed rule. OTS certifies that the Proposed Rule would not have a significant impact on a substantial number of small entities. The Small Business Administration has defined "small entities" for banking purposes as a bank or savings association with $175 million or less in assets. 13 CFR 121.201. Since OTS's Proposed Rule only applies to savings associations and savings and loan holding companies with $1 billion or more of assets, it will not apply to any small entities.

FHFA: The Regulatory Flexibility Act (5 U.S.C. 601 et seq.) requires that a rule that has a significant economic impact on a substantial number of small entities, small businesses, or small organizations must include an initial regulatory flexibility analysis describing the rule's impact on small entities. Such an analysis need not be undertaken if the agency has certified that the rule will not have a significant economic impact on a substantial number of small entities. 5 U.S.C. 605(b). FHFA has considered the impact of the final rule under the Regulatory Flexibility Act. FHFA certifies that the final rule is not likely to have a significant economic impact on a substantial number of small business entities because the rule is applicable only to FHFA's covered entities, which are not small entities for purposes of the Regulatory Flexibility Act.

NCUA: In accordance with the Regulatory Flexibility Act, 5 U.S.C. 601-612 (RFA), NCUA must publish an initial regulatory flexibility analysis with its proposed rule, unless NCUA certifies that the proposed rule would not have a significant economic impact on a substantial number of small entities, meaning those credit unions under $10 million in assets. NCUA Interpretive Ruling and Policy Statement 03-2, 68 FR 31949 (May 29, 2003). The Dodd-Frank Act section 956 and the NCUA's proposed rule only apply to credit unions of $1 billion in assets or more. Accordingly, NCUA certifies that the proposed rule would not have a significant economic impact on a substantial number of small entities since the credit unions covered under NCUA's proposed rule are not small entities for RFA purposes.

SEC: The Commission has prepared the following Initial Regulatory Flexibility Analysis (IRFA), in accordance with the provisions of the Regulatory Flexibility Act[35] regarding proposed Sections 248.201 through 248.207. The Commission encourages comments with respect to any aspect of this IRFA, including comments with respect to the number of small entities that may be affected by the proposed rules. Comments should specify the costs of compliance with the proposed rules and suggest alternatives that would accomplish the goals of the rules. Comments will be considered in determining whether a Final Regulatory Flexibility Analysis is required and will be placed in the same public file as comments on the proposed rules. Comments should be submitted to the Commission at the addresses previously indicated.

1. Small Entities Subject to the Rule

As described in more detail above, the proposed rules would implement section 956 of the Dodd-Frank Act, codified as 12 U.S.C. 5641. For purposes of Commission rulemaking in connection with the RFA, a small entity includes a broker-dealer: (i) with

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[35] 5 U.S.C. 603.

total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a-5(d) under the Exchange Act, and (ii) is not affiliated with any person (other than a natural person) that is not a small business or small organization as defined in this section.[36] Commission rules further provide that, for the purposes of the Investment Advisers Act of 1940, an investment adviser generally is a small entity if it: (i) has assets under management having a total value of less than $25 million; (ii) did not have total assets of $5 million or more on the last day of its most recent fiscal year; and (iii) does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of $25 million or more, or any person (other than a natural person) that had $5 million or more on the last day of its most recent fiscal year ("small adviser").[37]

Section 956 of the Dodd-Frank Act requires regulators, including the Commission, to jointly promulgate rules that apply to covered financial institutions with assets of at least $1 billion. The Commission believes that broker-dealers and investment advisers that would be subject to the proposed rule would either have $1 billion in assets or be affiliated with a firm that is characterized by at least $1 billion in assets. Therefore, the Commission preliminarily believes that there should not be any small broker-dealers or investment advisers impacted by this proposed rule.

2. Duplicative, Overlapping, or Conflicting Federal Rules

The Commission believes that there are no federal rules that duplicate, overlap, or conflict with the proposed rules.

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36 17 CFR 240.0-10(c). See 17 CFR 240.17a-5(d).

37 Rule 0-7(a). 17 CFR 275.0-7(a).

3. Significant Alternatives

Pursuant to section 3(c) of the RFA,[38] the Commission must consider certain types of alternatives, including (1) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities, (2) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities, (3) the use of performance rather than design standards, and (4) an exemption from coverage of the rule, or any part of the rule, for small entities.

The Commission does not believe it is necessary or appropriate to establish different compliance or reporting requirements or timetables; clarify, consolidate, or simplify compliance and reporting requirements under the rule for small entities; or summarily exempt small entities from coverage of the rule, or any part of the rule because the proposed rule will not apply to any small entities.

4. Request for Comments

The Commission encourages the submission of comments to any aspect of this portion of the IRFA. In particular, comments are encouraged on whether any small entities would be subject to the terms of the proposed rule. Comments should specify costs of compliance with the proposed rules and suggest alternatives that would accomplish the objective of the proposed rules.

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[38] 5 U.S.C. 603(c).

B. Paperwork Reduction Act

Request for Comment on Proposed Information Collection

In accordance with section 3512 of the Paperwork Reduction Act (PRA) of 1995 (44 U.S.C. § 3501-3521), agencies may not conduct or sponsor, and a respondent is not required to respond to, an information collection unless it displays a currently valid Office of Management and Budget (OMB) control number. The information collection requirements contained in this joint notice have been submitted by the FDIC, OCC, OTS, NCUA, and SEC to OMB for review and approval under section 3506 of the PRA and § 1320.11 of OMB's implementing regulations (5 C.F.R 1320). For the FHFA, the proposed rule does not contain any information collected from Fannie Mae, Freddie Mac and the Federal Home Loan Banks, including the Office of Finance, that requires the approval of OMB under the Paperwork Reduction Act (44 U.S.C. 3501 et seq.). The Board reviewed the proposed rule under the authority delegated to the Board by OMB. The proposed rule contains requirements subject to the PRA. The reporting requirements are found in § __.4 and the recordkeeping requirements are found in §§__.5(b)(3)(ii)(B), __.6(a), and __.6(b)(5).

Comments are invited on:

(a) Whether the collection of information is necessary for the proper performance of the agencies' functions, including whether the information has practical utility;

(b) The accuracy of the estimate of the burden of the information collection, including the validity of the methodology and assumptions used;

(c) Ways to enhance the quality, utility, and clarity of the information to be collected;

(d) Ways to minimize the burden of information collection on respondents, including through the use of automated collection techniques or other forms of information technology; and

(e) Estimates of capital or startup costs and costs of operation, maintenance, and purchase of services to provide information.

All comments will become a matter of public record. Comments should be addressed to:

FDIC: You may submit written comments, identified by the RIN, by any of the following methods:

- Agency Web Site: http://www.fdic.gov/regulations/laws/federal/propose.html. Follow the instructions for submitting comments on the FDIC Web site.
- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- E-mail: Comments@FDIC.gov. Include RIN 3064-AD56 on the subject line of the message.
- Mail: Robert E. Feldman, Executive Secretary, Attention: Comments, FDIC, 550 17th Street, NW., Washington, DC 20429.
- Hand Delivery/Courier: Comments may be hand delivered to the guard station at the rear of the 550 17th Street Building (located on F Street) on business days between 7:00 a.m. and 5:00 p.m.

Public Inspection: All comments received will be posted without change to http://www.fdic.gov/regulations/laws/federal/propose.html including any personal information provided. Comments may be inspected at the FDIC Public Information

Center, Room E-1002, 3501 Fairfax Drive, Arlington, VA 22226, between 9:00 a.m. and 5:00 p.m. on business days.

OCC: You should direct all written comments to: Communications Division, Office of the Comptroller of the Currency, Public Information Room, Mailstop 2-3, Attention: 1557-NEW, 250 E Street, SW., Washington, DC 20219. In addition, comments may be sent by fax to 202-874-5274, or by electronic mail to regs.comments@occ.treas.gov. You may personally inspect and photocopy comments at the OCC, 250 E Street, SW., Washington, DC 20219. For security reasons, the OCC requires that visitors make an appointment to inspect comments. You may do so by calling 202-874-4700. Upon arrival, visitors will be required to present valid government-issued photo identification and submit to security screening in order to inspect and photocopy comments.

OTS: Information Collection Comments, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW, Washington, DC 20552; send a facsimile transmission to 202-906-6518; or send an e-mail to infocollection.comments@ots.treas.gov. OTS will post comments and the related index on the OTS Internet site at http://www.ots.treas.gov. In addition, interested persons may inspect the comments at the Public Reading Room, 1700 G Street, NW., by appointment. To make an appointment, call 202-906-5922, send an e-mail to public.info@ots.treas.gov, or send a facsimile transmission to 202-906-7755.

NCUA: You may submit comments by any of the following methods (Please send comments by one method only):

- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.

- Agency Web site:

  http://www.ncua.gov/RegulationsOpinionsLaws/proposedregs/proposedregs.html. Follow the instructions for submitting comments.

- E-mail: Address to regcomments@ncua.gov. Include "[Your name] Comments on Notice of Proposed Rulemaking Incentive-based Compensation Arrangements" in the e-mail subject line.

- Fax: 703-518–6319. Use the subject line described above for e-mail.

- Mail: Address to David Chow, Deputy Chief Information Officer, National Credit Union Administration, 1775 Duke Street, Alexandria, VA 22314–3428.

- Hand Delivery/Courier: Same as mail address.

Additionally, you should send a copy of your comments to the OMB Desk Officer for the NCUA, by mail to U.S. Office of Management and Budget, 725 17th Street, NW., 10235, Washington, DC 20503, or by fax to 202-395–6974. The Paperwork Reduction Act requires OMB to make a decision concerning the collection of information contained in the proposed regulation between 30 and 60 days after publication of this document in the Federal Register. Therefore, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication. This does not affect the deadline for the public to comment to the NCUA on the proposed regulation.

SEC: Comments should be directed to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 10102, New Executive Office Building, Washington, DC 20503, and commenters also should send a copy of their comments to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090, and refer to File No. S7-12-11. We will post all public comments we receive without change, including any personal information you provide, such as your name and address, on the SEC Web site at http://www.sec.gov. Requests for materials submitted to OMB by the Commission with regard to this collection of information should be in writing, refer to File No. S7-12-11, and be submitted to the Securities and Exchange Commission, Office of Investor Education and Advocacy, 100 F Street, NE., Washington, DC 20549-0213. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this release in the *Federal Register*. A comment to OMB is best assured of having full effect if OMB receives it within 30 days after publication of this release.

Board: You may submit comments, identified by Docket No. R-1410, by any of the following methods:

- Agency Web site: http://www.federalreserve.gov. Follow the instructions for submitting comments on the http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm.
- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- E-mail: regs.comments@federalreserve.gov. Include docket number in the subject line of the message.
- FAX: 202-452-3819 or 202-452-3102.
- Mail: Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551.

All public comments are available from the Board's Web site at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm as submitted, unless modified for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper in Room MP-500 of the Board's Martin Building (20th and C Streets, NW.) between 9:00 a.m. and 5:00 p.m. on weekdays.

Proposed Information Collection

Title of Information Collection: Reporting and Recordkeeping Requirements Associated with Incentive-based Compensation Arrangements.

Frequency of Response: Annual.

Affected Public: Businesses or other for-profit.

Respondents:

FDIC: State nonmember banks or an insured U.S. branch of a foreign bank that has total consolidated assets of $1 billion or more.

OCC: National banks and Federal branches and agencies of foreign banks with $1 billion or more in total assets.

OTS: Savings associations and savings and loan holding companies with $1 billion or more in total assets.

NCUA: Credit unions with $1 billion or more in total assets.

SEC: Broker-dealers registered under section 15 of the Securities Exchange Act of 1934[39] with $1 billion or more in total assets and investment advisers, as such term is

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[39] 15 U.S.C. 78o.

defined in section 202(a)(11) of the Investment Advisers Act of 1940, with $1 billion or more in total assets[40] (collectively "covered BDs and IAs").

Board: State member banks, bank holding companies, and state-licensed uninsured branches and agencies of foreign banks with more than $1 billion in total assets, and the U.S. operations of foreign banking organizations with $1 billion or more in U.S. assets.

Abstract: Section 956 of the Dodd-Frank Act requires that the agencies prohibit incentive-based payment arrangements at a covered financial institution that encourage inappropriate risks by a financial institution by providing excessive compensation or that could lead to material financial loss. Under the Dodd-Frank Act, a covered financial institution also must disclose to its appropriate Federal regulator the structure of its incentive-based compensation arrangements sufficient to determine whether the structure provides "excessive compensation, fees, or benefits" or "could lead to material financial loss" to the institution. The Dodd-Frank Act does not require a covered financial institution to disclose compensation of individuals as part of this requirement.

Section __.4(a) would require covered financial institutions that have total consolidated assets of $1 billion or more to submit a report annually to the Agency that describes the structure of the covered financial institution's incentive-based compensation arrangements for covered persons and that is sufficient to allow an assessment of whether the structure or features of those arrangements provide or are likely to provide covered persons with excessive compensation, fees, or benefits to

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40 15 U.S.C. 80b-2(a)(11). By its terms, the definition of "covered financial institution" in Section 956 includes any firm that meets the definition of "investment adviser" under the Investment Advisers Act of 1940 ("Investment Advisers Act"), regardless of whether the firm is registered as an investment adviser under the Act. Banks and bank holding companies are generally excluded from the definition of "investment adviser" under section 202(a)(11) of the Investment Advisers Act.

covered persons or could lead to material financial loss to the institution. Section __.4(b) would require the following minimum standards:

(1) A clear narrative description of the components of the covered financial institution's incentive-based compensation arrangements applicable to covered persons;

(2) A succinct description of the covered financial institution's policies and procedures governing its incentive-based compensation arrangements;

(3) If the covered financial institution has total consolidated assets of $50 billion or more,[39] an additional succinct description of incentive-based compensation policies and procedures specific to the covered financial institution's:

(i) Executive officers; and

(ii) Other covered persons who the board of directors, or a committee thereof, of the institution has identified and determined under § ___.5(b)(3)(ii) of this part individually have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital, or overall risk tolerance;

(4) Any material changes to the covered financial institution's incentive-based compensation arrangements and policies and procedures made since the covered financial institution's last report submitted under paragraph (a)(1) of this section; and

(5) The specific reasons why the covered financial institution believes the structure of its incentive-based compensation plan: (i) does not provide covered

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39 For credit unions, $10 billion or more.

persons incentives to engage in behavior that is likely to cause the covered financial institution to suffer material financial loss; and (ii) does not provide covered persons with excessive compensation.

Section __.5(b)(3)(ii)(B) would require the board of directors of covered financial institutions that have total consolidated assets of $50 billion or more to approve and document the identification of those covered persons that individually have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital, or overall risk tolerance.

Section __.6(b)(5) would ensure that documentation of the institution's processes for establishing, implementing, modifying, and monitoring incentive-based compensation arrangements is maintained that is sufficient to enable the Agency to determine the institution's compliance with 12 U.S.C. § 5641.

Estimated Burden:

FDIC

Number of respondents: 301 (12 institutions with total consolidated assets of $50 billion or more and 289 institutions with total consolidated assets between $1 billion and $50 billion; 4,466 institutions with total consolidated assets below $1 billion are exempt). .

Burden per respondent for initial set up: 180 hours for institutions with $50 billion or more in total assets (80 hours for reporting requirements and 100 hours for recordkeeping requirements) and 70 hours for institutions between $1 billion and $50 billion in total assets (30 hours for reporting requirements and 40 hours for recordkeeping requirements).

Burden per respondent for ongoing compliance: 70 hours for institutions with $50 billion or more in total assets (40 hours for reporting requirements and 30 hours for recordkeeping requirements) and 25 hours for institutions between $1 billion and $50 billion in total assets (15 hours for reporting requirements and 10 hours for recordkeeping requirements).

Total FDIC annual burden: 30,455 hours (22,390 hours for initial set-up and 8,065 hours for ongoing compliance).

OCC

Number of respondents: 158 (18 institutions with total consolidated assets of $50 billion or more and 140 institutions with total consolidated assets between $1 billion and $50 billion; 1,215 institutions and 67 trust companies with total consolidated assets below $1 billion are exempt). .

Burden per respondent for initial set up: 180 hours for institutions with $50 billion or more in total assets (80 hours for reporting requirements and 100 hours for recordkeeping requirements) and 70 hours for institutions between $1 billion and $50 billion in total assets (30 hours for reporting requirements and 40 hours for recordkeeping requirements).

Burden per respondent for ongoing compliance: 70 hours for institutions with $50 billion or more in total assets (40 hours for reporting requirements and. 30 hours for recordkeeping requirements) and 25 hours for institutions between $1 billion and $50 billion in total assets (15 hours for reporting requirements and 10 hours for recordkeeping requirements).

Total OCC annual burden: 17,800 hours (13,040 hours for initial set-up and 4,760 hours for ongoing compliance).

OTS

Number of respondents: 163 (17 institutions with total consolidated assets of $50 billion or more and 146 institutions with total consolidated assets between $1 billion and $50 billion.

Burden per respondent for initial set up: 180 hours for institutions with $50 billion or more in total assets (80 hours for reporting requirements and 100 hours for recordkeeping requirements) and 70 hours for institutions between $1 billion and $50 billion in total assets (30 hours for reporting requirements and 40 hours for recordkeeping requirements).

Burden per respondent for ongoing compliance: 70 hours for institutions with $50 billion or more in total assets (40 hours for reporting requirements and 30 hours for recordkeeping requirements) and 25 hours for institutions between $1 billion and $50 billion in total assets (15 hours for reporting requirements and 10 hours for recordkeeping requirements).

Total OTS annual burden: 18,120 hours (13,280 hours for initial set-up and 4,840 hours for ongoing compliance).

NCUA

Number of respondents: 184 (6 institutions with total consolidated assets of $10 billion or more and 178 institutions with total consolidated assets between $1 billion and $10 billion).

Burden per respondent for initial set up: 180 hours for institutions with $10 billion or more in total assets (80 hours for reporting requirements and 100 hours for recordkeeping requirements) and 70 hours for institutions between $1 billion and $10 billion in total assets (30 hours for reporting requirements and 40 hours for recordkeeping requirements).

Burden per respondent for ongoing compliance: 70 hours for institutions with $10 billion or more in total assets (40 hours for reporting requirements and 30 hours for recordkeeping requirements) and 25 hours for institutions between $1 billion and $10 billion in total assets (15 hours for reporting requirements and 10 hours for recordkeeping requirements).

Total NCUA annual burden: 18,410 hours (13,540 hours for initial set-up and 4,870 hours for ongoing compliance).

SEC

Number of respondents: The proposed rule would establish additional reporting and recordkeeping burdens for broker-dealers that are covered financial institutions ("covered BDs and IAs") with assets of at least $50 billion, as compared to covered BDs and IAs with assets between $1 billion and $50 billion. The Commission estimates that approximately 200 respondents (approximately 130 broker-dealers and approximately 70 investment advisers) would be affected generally by the proposed rules, and that approximately 30 of the 200 respondents would be affected by proposed §§ 248.204(c)(3) and 248.205(b)(3)(ii)(B).[40]

40 Each Federal regulator has proposed how to calculate a firm's "total consolidated assets". For broker-dealers, the determination of whether the broker-dealer had $1 billion in assets would be made by reference to the broker-dealer's year-end audited consolidated statement of financial condition filed with the Commission pursuant to Rule 17a-5. For investment advisers, asset size would be determined by the

A) **Proposed Section 248.204 (Required Reports)**

The Commission, jointly with the other Agencies, proposes that covered BDs and IAs be required to describe the structure of the firms' incentive-based compensation arrangements for covered persons in a manner that is sufficient to allow an assessment of whether the structure or features of those arrangements provide or are likely to provide covered persons with excessive compensation, fees, or benefits to covered persons or could lead to material financial loss to the firm. Proposed § 248.204(c)(1) would require a narrative description of the components of the incentive-based compensation arrangements applicable to covered persons, specifying the types of covered persons to which they apply. Proposed § 248.204(c)(2) would require that covered BDs and IAs provide a succinct description of their incentive-based compensation policies and procedures. Proposed § 248.204(c)(3) would require that covered BDs and IAs with total consolidated assets of $50 billion or more provide the Commission with a succinct description of incentive-based compensation policies and procedures applicable to executive officers and other covered persons whom the board of directors, or a committee thereof, has identified as having the ability to expose the institution to possible losses that are substantial in relation to the firm's size, capital, or overall risk tolerance. Proposed § 248.204(c)(4) would require covered BDs and IAs to describe the material changes to the

adviser's total assets shown on the balance sheet for the adviser's most recent fiscal year end. Data from the SEC's Office of Risk, Strategy and Financial Innovation indicates that there are 132 registered broker-dealers with assets of $1 billion or more and 18 broker-dealers with assets of at least $50 billion. Most investment advisers currently do not report to the Commission the amount of their own assets, so the Commission is unable to determine how many have $1 billion or more in assets and $50 billion or more in total consolidated assets. See Form ADV, Part 1A, Item 12. The Commission estimates that advisers with assets under management of $100 billion or more would have total consolidated assets of $1 billion or more. Based on data from the Investment Adviser Registration Depository ("IARD"), the SEC's Division of Investment Management estimates that 68 registered advisers with assets under management of at least $100 billion would have assets of $1 billion or more, and 7 registered advisers with assets under management of at least $500 billion would have total consolidated assets of at least $50 billion. The Commission has rounded these numbers to 70 and 10 for purposes of its analysis.

firm's incentive based compensation arrangements. Proposed § 248.204(c)(5) would require each covered BD and IA to describe the specific reasons why it believes the structure of its incentive-based compensation does not encourage inappropriate risks by the covered financial institution by providing covered persons with excessive compensation or incentive-based compensation that could lead to material financial loss to the covered financial institution.

Based on the initial and ongoing burden the Commission estimated in connection with the adoption of the executive compensation reporting requirements for public companies filing Form10-Ks under the Exchange Act (i.e. Item 402 of Regulation S-K), the Commission estimates that the burden for the covered BD and IA respondents imposed by the proposed reporting requirements would be 100 hours.[41] Since the proposed rule does not provide for different reporting requirements for smaller covered BDs and IAs with assets between $1 billion and $50 billion and for larger firms with assets of at least $50 billion, the Commission has not estimated separate reporting burdens for larger covered BDs and IAs. Therefore, the Commission estimates a collective reporting burden of 20,000 hours for covered BDs and IAs.[42]

B) Documentation of Determining Designated Persons (Section 248.205(b)(3)(ii)(B))

For covered BDs and IAs with assets of at least $50 billion, proposed § 248.205(b)(3)(ii)(B) would require a firm's board of directors, or a committee thereof, to identify those covered persons (other than executive officers) that individually have the

41 The Commission estimated that public company respondents would incur approximately 95 hours of annual burden in connection with the adoption of Item 402 of Regulation S-K. See Securities Act of 1933 Release No. 8432A and Securities Exchange Act Release No. 54302A.(August 29, 2006), 71 FR 53158, 53217 (September 8, 2006) (S7-03-06). The Commission is rounding this number up to 100 for the instant proposed rule estimate.

42 200 covered BDs and IAs x 100 hours = 20,000 hours.

ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital, or overall risk tolerance. These covered persons may include, for example, traders with large position limits relative to the institution's overall risk tolerance and other individuals that have the authority to place at risk a substantial part of the capital of the covered financial institution. The Agencies propose that the compensation decisions applicable to such persons must be approved by the firm's board of directors or a committee of the board and that the covered BD or IA document the compensation decisions made by the board or its committee.

The Commission estimates that each covered BD and IA with assets of at least $50 billion would incur 20 hours of burden initially to comply with the proposed recordkeeping requirements associated with the proposed rule and 10 hours of burden on an ongoing basis. Therefore, the Commission estimates an initial collective recordkeeping burden in connection with the documentation requirement provided in § 248.205(b)(3)(ii)(B) is 600 hours for covered BDs and IAs with assets of at least $50 billion.[43] The Commission estimates the ongoing collective recordkeeping burden in connection with this requirement to be 300 hours for covered BDs and IAs with assets of at least $50 billion.[44]

C) Required Policies and Procedures

Proposed § 248.206(a) would require covered financial institutions to adopt and maintain policies and procedures reasonably designed to ensure and monitor compliance with 12 U.S.C. 5641, commensurate with the size and complexity of the organization and the scope and nature of its use of incentive-based compensation. As described in further

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[43] 30 covered BDs and IAs with assets of at lêast $50 billion x 20 hours = 600 hours

[44] 30 covered BDs and IAs with assets of at least $50 billion x 10 hours = 300 hours.

detail above, proposed § 248.206(b) would require that the policies and procedures, at a minimum, are consistent with the disclosure requirements and prohibitions in other parts of the proposed rule, ensure that risk management or oversight personnel have a role in designing and assessing incentive-based compensation arrangements, provide for independent monitoring of the incentive-based compensation awards, risks taken and actual outcomes, require that a covered financial institution's board receive data and analysis from management and other sources sufficient to enable the board to assess whether the incentive-based compensation arrangements are consistent with 12 U.S.C. 5641, and require sufficient documentation of the covered financial institution's incentive-based compensation arrangements to enable the Commission to determine the covered BDs or IAs compliance with 12 U.S.C. 5641. In addition, the proposal would require that the covered BDs' and IAs' policies and procedures include certain features when a firm uses deferral in connection with an incentive-based compensation arrangement, and that the policies and procedures subject incentive-based compensation arrangements to a corporate governance framework.

Many covered BDs and IAs are already conforming to the incentive-based compensation standards reflected in the Guidance because they are affiliated with banking organizations supervised by the FRB, OCC, OTS or FDIC that have already altered their incentive-based compensation arrangements and policies and procedures following the publication of the Guidance. The Guidance applies to all banking organizations supervised by the FRB, OCC, OTS or FDIC, including national banks, State member banks, State nonmember banks, savings associations, U.S. bank holding companies, savings and loan holding companies, the U.S. operations of foreign banks with a branch, agency or commercial lending company in the United States, and Edge and agreement corporations (collectively "banking organizations").[45] Based upon information filed with the Commission and the staff's discussions with a number of BDs and its review of the public filings of covered BDs, IAs and certain parent companies, the Commission believes that covered BDs and IAs affiliated with banking organizations ("covered bank BDs and IAs") have already altered their incentive-based compensation policies and procedures and corresponding arrangements in conjunction with their affiliated banking organizations that are subject to the Guidance. Based on public filings with the Commission, the SEC estimates that there are approximately 25 covered bank BDs and IAs with total consolidated assets of at least \$50 billion and approximately 85 covered bank BDs and IAs with total consolidated assets between \$1 billion and \$50 billion.[46] Therefore, covered bank BDs and IAs should bear significantly less burden than those covered BDs and IAs not already subject to the Guidance ("covered non-bank BDs and IAs") to develop and maintain policies and procedures as required in the proposed rules. The Commission requests comment on its estimated number of covered bank BDs and IAs.

The Commission believes that the covered bank BDs and IAs would incur approximately the same recordkeeping burden as the banking organizations. Based on the initial estimates of recordkeeping burden provided by FRB, OCC, FDIC and OTS for

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45 See Guidance 75 FR at 36398.

46 The Commission estimates that there are approximately 20 covered bank BDs with assets of at least \$50 billion and 35 covered bank BDs with assets between \$1 billion and \$50 billion. The Commission bases the estimates for covered bank BDs upon data submitted to the Commission in FOCUS reports (i.e. Form X-17A-5 Part II). The Commission estimates that there are approximately 5 covered bank IAs with assets of at least \$50 billion and 50 covered bank IAs with assets between \$1 billion and \$50 billion. The estimates for covered bank IAs are based upon data submitted to the Commission in Form ADV (i.e. Form ADV Part 1A, Items 6.A.(6) and 7.A.(5)).

proposed § 248.206, the Commission estimates an initial recordkeeping burden of 80 hours for each covered bank BD and IA with $50 billion or more in total consolidated assets and 40 hours of initial recordkeeping burden for each covered bank BD and IA with total consolidated assets between $1 billion and $50 billion. Based on the ongoing estimates of recordkeeping burden provided by FRB, OCC, FDIC and OTS, the Commission believes that each covered bank BD and IA respondent with total consolidated assets of at least $50 billion would incur approximately 30 hours of ongoing recordkeeping burden and each covered bank BD and IA respondent with total consolidated assets between $1 billion and $50 billion would incur approximately 10 hours of recordkeeping burden on an ongoing basis.

For covered non-bank BDs and IAs, the Commission estimates a significantly higher burden, namely the amount of burden that the banking agencies originally estimated in the Guidance (480 hours of initial burden, rounded up to 500 in the instant proposal and 40 hours of ongoing burden)[47] in addition to the amounts that the FRB, OTS, FDIC and OCC estimated in connection with the instant proposed rule. The Commission estimates that there are approximately 75 covered non-bank BDs with assets between $1 billion and $50 billion, 10 covered non-bank IAs with assets between $1 billion and $50 billion and 5 covered non-bank IAs with assets of at least $50 billion.[48]

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47 See Guidance, 75 FR at 36403.

48 The Commission estimates that there are approximately 75 covered non-bank BDs with assets between $1 billion and $50 billion . The Commission estimates that there are approximately 5 covered non-bank IAs with assets of at least $50 billion and 10 covered non-bank IAs with assets between $1 billion and $50 billion. The Commission bases these estimates upon data submitted to the Commission in FOCUS reports (i.e. Form X-17A-5 Part II) and in Form ADV (i.e. Form ADV Part 1A, Items 6.A.(6) and 7.A.(5)). See supra note 46. It is difficult to determine whether any unregistered advisers are non-bank IAs that are not subject to the Guidance.

Therefore, for covered non-bank BDs and IAs, the Commission estimates an initial recordkeeping burden estimate of 580 hours[49] for covered BDs and IAs with $50 billion or more in total consolidated assets and 540 hours[50] of recordkeeping burden for covered BDs and IAs with total consolidated assets between $1 billion and $50 billion. The Commission estimates that covered non-bank BD and IA respondents with total consolidated assets of at least $50 billion would incur approximately 70 hours[51] of ongoing recordkeeping burden while those covered non-Bank BDs and IAs with total consolidated assets between $1 billion and $50 billion would incur approximately 50 hours[52] of ongoing recordkeeping burden.

Total SEC initial and annual recordkeeping and reporting burdens (from proposed Section 248.205(b)(iii)(2)(B) and proposed Section 248.206):

	Covered bank BDs and IAs ($50B +)	Covered bank BDs and IAs ($1B-$50B)	Covered non-bank BDs and IAs ($50B +)	Covered non-bank BDs and IAs ($1B-$50B)
Initial Reporting	2,500 hours[53]	8,500 hours[54]	500 hours[55]	8,500 hours[56]

49 500 hours (from Guidance) + 80 hours (from the estimate provided by the Fed, OCC, FDIC and OTS in instant proposed rule) = 580 hours.

50 500 hours (from Guidance) + 40 hours (from the estimate provided by the Fed, OCC, FDIC and OTS in instant proposed rule) = 540 hours.

51 40 hours (from Guidance) + 30 hours (from the estimate provided by the Fed, OCC, FDIC and OTS in instant proposed rule) = 70 hours.

52 40 hours (from Guidance) + 10 hours (from the estimate provided by the Fed, OCC, FDIC and OTS in instant proposed rule) = 50 hours.

53 (20 covered bank BDs with assets of at least $50B + 5 covered bank IAs with assets of at least $50B) x 100 hours = 2,500 hours.

54 (35 covered bank BDs with assets between $1B and $50B + 50 covered bank IAs with assets between $1B and $50B) x 100 hours = 8,500 hours.

55 5 covered non-bank IAs with assets of at least $50B x 100 hours = 500 hours.

56 (75 covered non-bank BDs with assets between $1B and $50B + 10 covered non-bank IAs with assets between $1B and $50B) x 100 hours = 8,500 hours.

Initial Recordkeeping	2,500 hours[57]	3,400 hours[58]	3,000 hours[59]	46,000 hours[60]

	Covered bank BDs and IAs ($50B +)	Covered bank BDs and IAs ($1B-$50B)	Covered non-bank BDs and IAs ($50B +)	Covered non-bank BDs and IAs ($1B-$50B)
Ongoing Reporting	2,500 hours[61]	8,500 hours[62]	500 hours[63]	8,500 hours[64]
Ongoing Recordkeeping	1,000 hours[65]	1,000 hours[66]	400 hours[67]	4,300 hours[68]

D. External Costs

The Commission also believes that the proposed rules would likely generate external costs to the covered BDs and IAs, particularly at the stage of preparing the initial

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[57] (20 covered bank BDs with assets of at least $50B + 5 covered bank IAs with assets of at least $50B) x 80 hours + ((20 covered bank BDs + 5 covered bank IAs) x 20 hours in connection with proposed Section 248.205(b)(3)(ii)(B)) = 2,500 hours.

[58] (35 covered bank BDs with assets between $1B and $50B + 50 covered bank IAs with assets between $1B and $50B) x 40 hours = 3,400 hours.

[59] 5 covered non-bank IAs with assets of at least $50B x 580 hours + ((5 covered non-bank IAs with assets of at least $50B) x 20 hours in connection with proposed Section 248.205(b)(3)(ii)(B)) = 3,000 hours.

[60] (75 covered non-bank BDs with assets between $1B and $50B + 10 covered non-bank IAs with assets between $1B and $50B) x 540 hours = 45,900 hours.

[61] (20 covered bank BDs with assets of at least $50B + 5 covered bank IAs with assets of at least $50B) x 100 hours = 2,500 hours.

[62] (35 covered bank BDs with assets between $1B and $50B + 50 covered bank IAs with assets between $1B and $50B)x 100 hours = 8,500 hours.

[63] 5 covered non-bank IAs with assets of at least $50B x 100 hours = 500 hours.

[64] (75 covered non-bank BDs with assets between $1B and $50B + 10 covered non-bank IAs with assets between $1B and $50B) x 100 hours = 8,500 hours.

[65] (20 covered bank BDs with assets of at least $50B + 5 covered bank IAs with assets of at least $50B) x 30 hours + ((20 covered bank BDs + 5 covered bank IAs) x 10 hours in connection with proposed Section 248.205(b)(3)(ii)(B)) = 900 hours.

[66] (35 covered bank BDs with assets between $1B and $50B + 50 covered bank IAs with assets between $1B and $50B) x 10 hours = 850 hours.

[67] 5 covered non-bank IAs with assets of at least $50B x 70 hours + ((5 covered non-bank IAs with assets of at least $50B) x 10 hours in connection with proposed Section 248.205(b)(3)(ii)(B)) = 400 hours.

[68] (75 covered non-bank BDs with assets between $1B and $50B + 10 covered non-bank IAs with assets between $1B and $50B) x 50 hours = 4,250 hours.

reports required by § 248.204 and initially developing and implementing the policies and procedures in compliance with § 248.206. Covered BDs and IAs may elect to hire various types of professionals, including attorneys, benefits consultants, and accountants. The Commission estimates that the covered BDs and IAs would hire professionals to prepare the necessary reports and develop and maintain the necessary policies and procedures at approximately the same hourly level as the covered BDs and IAs assume internally (e.g. covered bank BDs and IAs with at least $50 billion in assets would collectively use approximately the equivalent of 2,500 hours worth of professionals' time to prepare the required reports, in addition to the covered bank BDs' and IAs' internal burden to prepare them).

The Commission believes that there would be approximately an equal balance of attorneys,[69] benefits consultants,[70] actuaries[71] and accountants[72] that are hired at each covered BD or IA. The chart below summarizes the external costs that the Commission estimates covered BDs and IAs would assume collectively in connection with the proposed rule. The Commission requests comments on these external cost estimates,

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69 An outside attorney's salary range is estimated at $400 an hour based on industry sources. See Securities Exchange Act Release No. 62174 (May 26, 2010) at note 510, 75 FR 32556 (June 8, 2010) (S7-15-09). The Commission requests comment on this estimate.

70 An outside management consultant's salary range (national averages) is available from www.payscale.com. Using their data from the 75th percentile, adjusting it for an 1800-hour work year, and multiplying by the 5.35 factor which normally is used to include benefits but here is used as an approximation to offset the fact that New York salaries are typically higher than the rest of the country, the result is $596 per hour (rounded to $600). The Commission requests comment on this estimate.

71 An outside actuary's salary range (national averages) is available from www.payscale.com. Using their data from the 75th percentile, adjusting it for an 1800-hour work year, and multiplying by the 5.35 factor which normally is used to include benefits but here is used as an approximation to offset the fact that New York salaries are typically higher than the rest of the country, the result is $330 per hour. The Commission requests comment on this estimate.

72 An outside accountant's salary range is available from the U.S. Bureau of Labor Statistics, Occupational Employment Statistics Web site. Using their data for median salaries from New York State, which has the highest rates in the country, and multiplying by the 5.35 factor which is used to include benefits, the result is $250 per hour. The Commission requests comment on this estimate.

including the hourly rate that the Commission estimates for external attorneys, benefits consultants, actuaries and accountants.

Total SEC estimated external recordkeeping costs:

	Covered bank BDs and IAs ($50B +)	Covered bank BDs and IAs ($1B-$50B)	Covered non-bank BDs and IAs ($50B +)	Covered non-bank BDs and IAs ($1B-$50B)
Initial Reporting	$1 million[73]	$3.4 million[74]	$200,000[75]	$3.4 million[76]
Initial Recordkeeping	$1 million[77]	$1.3 million[78]	$1.2 million[79]	$18 million[80]

	Covered bank BDs and IAs ($50B +)	Covered bank BDs and IAs ($1B-$50B)	Covered non-bank BDs and IAs ($50B +)	Covered non-bank BDs and IAs ($1B-$50B)
Ongoing Reporting	$1 million[81]	$3.4 million[82]	$200,000[83]	$3.4 million[84]

73 2,500 hours x [(25% x $400/hour) + (25% x $600/hour) + (25% x $330/hour) + (25% x $250/hour)] = $987,500.

74 8,500 hours x [(25% x $400/hour) + (25% x $600/hour) + (25% x $330/hour) + (25% x $250/hour)] = $3,357,500.

75 500 hours x [(25% x $400/hour) + (25% x $600/hour) + (25% x $330/hour) + (25% x $250/hour)] = $197,500

76 8,500 hours x [(25% x $400/hour) + (25% x $600/hour) + (25% x $330/hour) + (25% x $250/hour)] = $3,357,500.

77 2,500 hours x [(25% x $400/hour) + (25% x $600/hour) + (25% x $330/hour) + (25% x $250/hour)] = $987,500.

78 3,400 hours x [(25% x $400/hour) + (25% x $600/hour) + (25% x $330/hour) + (25% x $250/hour)] = $1,343,000.

79 3,000 hours x [(25% x $400/hour) + (25% x $600/hour) + (25% x $330/hour) + (25% x $250/hour)] = $1,185,000.

80 46,000 hours x [(25% x $400/hour) + (25% x $600/hour) + (25% x $330/hour) + (25% x $250/hour)] = $18,170,000.

81 2,500 hours x [(25% x $400/hour) + (25% x $600/hour) + (25% x $330/hour) + (25% x $250/hour)] = $987,500.

Ongoing Recordkeeping	\$400,000[85]	\$400,000[86]	\$150,000[87]	\$1.7 million[88]

Board

Number of respondents: 664 (59 institutions with total consolidated assets of \$50 billion or more and 605 institutions with total consolidated assets between \$1 billion and \$50 billion).

Burden per respondent for initial set up: 180 hours for institutions with \$50 billion or more in total consolidated assets (80 hours for reporting requirements and 100 hours for recordkeeping requirements) and 70 hours for institutions between \$1 billion and \$50 billion in total consolidated assets (30 hours for reporting requirements and 40 hours for recordkeeping requirements).

Burden per respondent for ongoing compliance: 70 hours for institutions with \$50 billion or more in total consolidated assets (40 hours for reporting requirements and 30 hours for recordkeeping requirements) and 25 hours for institutions between \$1 billion and \$50 billion in total consolidated assets (15 hours for reporting requirements and 10 hours for recordkeeping requirements).

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82 8,500 hours x [(25% x \$400/hour) + (25% x \$600/hour) + (25% x \$330/hour) + (25% x \$250/hour)] = \$3,357,500.

83 500 hours x [(25% x \$400/hour) + (25% x \$600/hour) + (25% x \$330/hour) + (25% x \$250/hour)] = \$197,500.

84 8,500 hours x [(25% x \$400/hour) + (25% x \$600/hour) + (25% x \$330/hour) + (25% x \$250/hour)] = \$3,357,500.

85 1,000 hours x [(25% x \$400/hour) + (25% x \$600/hour) + (25% x \$330/hour) + (25% x \$250/hour)] = \$395,000

86 1,000 hours x [(25% x \$400/hour) + (25% x \$600/hour) + (25% x \$330/hour) + (25% x \$250/hour)] = \$395,000

87 400 hours X [(25% x \$400/hour) + (25% x \$600/hour) + (25% x \$330/hour) + (25% x \$250/hour)] = \$158,000

88 4,300 hours X [(25% x \$400/hour) + (25% x \$600/hour) + (25% x \$330/hour) + (25% x \$250/hour)] = \$1,698,500

Total Board annual burden: 72,225 hours (52,970 hours for initial set-up and 19,255 hours for ongoing compliance).

C. OTS Executive Orders 12866 and 13563 Determination

Executive Order 13563, "Improving Regulation and Regulatory Review," affirms and supplements Executive Order 12866, "Regulatory Planning and Review," which requires federal agencies to prepare a regulatory impact analysis for agency actions that are found to be "significant regulatory actions." Significant regulatory action means any regulatory action that is likely to result in a rule that may:

(1) Have an annual effect on the economy of $100 million or more or adversely affect in a material way the economy, a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local, or tribal governments or communities;

(2) Create a serious inconsistency or otherwise interfere with an action taken or planned by another agency;

(3) Materially alter the budgetary impact of entitlements, grants, user fees, or loan programs or the rights and obligations of recipients thereof; or

(4) Raise novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in the Executive order.[89]

Based on its initial assessment, OTS anticipates that the proposed rule (if the final rule is the same as the proposed rule) would not be economically significant. Nonetheless, OTS solicits comment on the economic impact.

[89] See 58 FR 51735 (Oct. 4, 1993), as amended.

OTS does not anticipate that the proposal would create a serious inconsistency or otherwise interfere with an action taken or planned by another agency. OTS's proposal is essentially the same as the proposal of every other federal agency regulating the financial services industry. Thus, rather than creating any inconsistency, by being part of this joint interagency proposal, OTS's portion adds to the consistency of regulations on incentive-based compensation that will encompass the financial services industry.

OTS does not anticipate that the proposal would materially alter the budgetary impact of entitlements, grants, user fees, or loan programs or the rights and obligations of recipients thereof. The proposal does not have any provisions related to those subjects.

The Office of Management and Budget's Office of Information and Regulatory Affairs has designated this proposed rule to be a significant regulatory action that is likely to result in a rule that may raise novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in Executive Orders 12866 and 13563. OTS notes that the proposal does raise some similar issues as were raised by the Banking Agency Guidance issued June 25, 2010, and the 1995 federal banking agency guidelines implementing the compensation-related and other safety and soundness standards in section 39 of the FDIA (codified at 12 CFR pt. 570, App. A).

Need for Regulatory Action

The proposed rule is required by section 956 of the Dodd-Frank Act. Thus, the proposal is needed to fulfill the statutory mandate that OTS and the other agencies participating in this joint rulemaking prescribe regulations or guidelines that:

1. Prohibit incentive-based payment arrangements, or any feature of any such arrangement, at a covered financial institution that the Agencies determine encourage inappropriate risks by a financial institution by providing excessive compensation or that could lead to a material financial loss.
2. Require covered financial institutions to disclose to its appropriate Federal regulator the structure of its incentive-based compensation arrangements sufficient to determine whether the structure provides "excessive compensation, fees, or benefits" or "could lead to material financial loss" to the institution.
3. Are comparable to the existing compensation-related safety and soundness standards applicable to insured depository institutions under section 39 of the FDIA (12 U.S.C. 1831p-1(c)) (12 CFR pt. 570, App. A for OTS).

The legislative history of the Dodd-Frank Act describes the reasons Congress believed section 956 of the Dodd-Frank Act was needed.[90] Further information and analysis is contained in the Final Report of the Financial Crisis Inquiry Commission.[91] OTS's portion of the proposed rule is intended to enhance the regulatory oversight of incentive compensation schemes at larger OTS-regulated savings associations and savings and loan holding companies so as to help ensure that compensation at such institutions is neither excessive in itself nor encourages excessive risk taking.

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[90] See H.R. Rep. 111-236, Corporate and Financial Institution Compensation Fairness Act of 2009, at 6 (2009). For additional legislative history, see Compensation Structure and Systemic Risk: Hearing Before the H. Comm. on Financial Services, 111th Cong. (2009).

[91] Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, January 2011, available at http://c0182732.cdn1.cloudfiles.rackspacecloud.com/fcic_final_report_full.pdf. The report contains discussion of financial sector executive compensation practices, including on pages 61-65.

Scope of Proposed Rule

Section 956 of the Dodd-Frank Act defines "covered financial institutions" to include depository institutions and depository institution holding companies, as defined in section 3 of the FDIA, with assets of $1 billion or more. OTS's portion of the proposed rule applies to savings associations and savings and loan holding companies with $1 billion or more in total consolidated assets that have incentive-based compensation programs.

With regard to savings associations, as of December 31, 2010, OTS supervised 731 savings associations with a combined total of $932 billion in assets. The largest savings association had assets of $88 billion. Only three other savings associations had assets greater than $50 billion. The smallest savings association had assets of $3.5 million. Of the 731 savings associations, 103 have more than a $1 billion each in total assets and thus are covered by the proposed rule (assuming they all have incentive-based compensation programs). Those 103 savings associations represent 85% of all thrift industry assets ($793 billion of the total $932 billion). To put this in context, however, the latest available data on commercial banks (dated September 30, 2010) show 508 commercial banks with assets of $1 billion or more, but with combined total assets of $11 trillion, more than eleven times the amount of assets compared to OTS supervised savings associations of $1 billion or more.

With regard to savings and loan holding companies, as of December 31, 2010, OTS supervised 102 savings and loan holding companies. Savings and loan holding companies are companies that own or control one or more savings associations. Excluding 42 shell holding companies that do not have incentive-based compensation programs, there are 60 savings and loan holding companies with aggregate consolidated assets of $3.1 trillion dollars that are covered by the proposed rule (assuming they all have incentive-based compensation programs). Individually, these companies have consolidated assets ranging from $1 billion to over $750 billion, and vary in complexity as well as size. They conduct a wide range of activities beyond those conducted by the saving association(s) they control. These range from activities closely related to banking, such as insurance and securities brokerage, to activities conducted by large, multinational corporations, such as retailing and manufacturing.

Therefore, altogether, OTS's portion of the proposed rule would affect a maximum of 163 OTS-supervised institutions (103 savings associations and 60 savings and loan holding companies).

OTS further notes that the Board, OCC, and FDIC will assume supervisory and rulemaking responsibility for entities currently supervised and regulated by OTS on the transfer date provided in Title III of the Dodd-Frank Act. That date is expected to be July 21, 2011. These agencies expect to adopt, or incorporate, as appropriate, any final rule adopted by OTS as part of this rulemaking for relevant covered financial institutions that come under their respective supervisory authority after the transfer date.

Types of Impact of Proposed Rule

OTS reviewed existing practices at a subset of these 163 institutions to determine how much the rule would add to the current cost of administering incentive-based compensation programs. A covered financial institution would have to:

1. Submit an annual report to OTS describing the structure of its incentive-based compensation program in sufficient detail for OTS to determine whether the

program provides excessive compensation or compensation that could lead to material loss to the institution.. The annual report would have to include an analysis of the characteristics of the incentive-based compensation program that prevent excessive compensation and/or mitigate risk of material financial loss.

2. Review and, if necessary, redesign its incentive-based compensation system to ensure it has the elements necessary to adequately manage the risks arising from incentive-based compensation. The rule would contain a list of the minimum elements to be included in the policies and procedures.
3. Conduct ongoing monitoring and, as appropriate, auditing of the incentive-based compensation program to ensure that it does, in fact, allocate incentive-based compensation in a way that is not excessive and does not encourage inappropriate risks.

In estimating the implementation costs to covered financial institutions, OTS assumed that costs would generally fall in four areas:

1. Initially reviewing incentive-based compensation programs to determine whether program modifications are needed;
2. Modifying incentive-based compensation programs, where needed;
3. Ongoing monitoring of incentive-based compensation programs to ensure continued compliance; and
4. Preparing and submitting required annual reports on the programs to OTS.

Almost all of the covered financial institutions have incentive-based compensation programs. Each covered financial institution, therefore, would need to perform an initial review to determine whether modifications would be needed. This initial review would also include the analysis necessary to prepare the first report to OTS.

Those institutions needing modifications would have to expend further resources to design and implement compliant systems that fit the institution's business strategy and internal structure. The complexity and length of this process would vary depending on the size of the institution, the scope of the institution's incentive-based compensation program, and the extent of necessary modifications.

The rule's burden would be minimized by granting covered financial institutions the latitude to employ a variety of means to mitigate the risks posed by their current incentive-based compensation programs. While institutions would have to develop policies and procedures that provide clear expectations, institutions could choose the incentive-based compensation risk balancing measures that best address their employees and their risks.[92]

OTS's provisional assessment is that most covered financial institutions would have to make minimal changes to their systems covering:

1. Compensation to executives;
2. The oversight exercised by the board and compensation committee;
3. The scope of risk management; and
4. The role of internal audit.

Some of the key restrictions in the proposed rule are restrictions that covered financial institutions are already observing. Section 563h.5(a) would provide that a covered financial institution must not establish or maintain any type of incentive-based

92 The Federal Banking Agency Guidance presents and discusses these measures.

compensation arrangement, or any feature of any such arrangement, that encourages inappropriate risks by the covered financial institution by providing a covered person with excessive compensation. Section 563h.5(b) would provide that a covered financial institution must not establish or maintain any type of incentive-based compensation arrangement, or any feature of any such arrangement, that encourages inappropriate risks by the covered financial institution, by providing incentive-based compensation to covered persons, either individually or as part of a group of persons who are subject to the same or similar incentive-based compensation arrangements, that could lead to material financial loss to the covered financial institution.

OTS and the other federal banking regulators have long required depository institutions to conform their compensation practices to principles of safety and soundness.[93] Since 1995, OTS and the other federal banking regulators have specifically prohibited depository institutions from paying compensation, fees, and benefits that are excessive or that could lead to material financial loss to the institutions.[94] Since 1995, OTS and the other federal banking regulators have also specified that compensation that could lead to material financial loss to an institution is prohibited as an unsafe and unsound practice.[95] The standards specified in § 563h.5(a)(2) for determining whether an incentive-based compensation arrangement provides excessive compensation are taken directly from the existing 1995 guidelines.[96]

Since June 25, 2010, OTS and the other federal banking regulators have maintained guidance designed to help ensure that incentive-based compensation policies

93 See section 39(c) of FDIA, 12 U.S.C. 1831p–1(c).

94 See 12 CFR pt. 570, App. A, paragraph II.I.

95 See 12 CFR pt. 570, App. A, paragraph III.B.

96 See 12 CFR pt. 570, App. A, paragraph III.A.

at banking organizations do not encourage imprudent risk-taking and are consistent with the safety and soundness of the organization, including guidance on methods such as deferral that make compensation more sensitive to risk. The requirements specified in § 563h.5(b)(2) for avoiding incentive-based compensation arrangements that could lead to material financial loss are taken directly from the guidance.[97] Most covered financial institutions, therefore, already have the listed elements in place. Further, a recent report of the Basel Committee on Banking Supervision (BCBS) noted that most larger institutions already use management accounting to map company performance to business units, and largely employ risk-adjusted return to capital and other economic efficiency measures to assess performance when making incentive-based compensation allocation decisions.[98]

Even the reporting requirements of § 563h.4 of the proposed rule would not be completely new for many institutions. Publicly listed institutions already disclose their incentive-based compensation systems.[99]

As a group, covered financial institutions are likely to make more significant changes to incentive-based compensation programs for non-executive employees and, to some degree, principal shareholders. While institutions have in place most of the internal policies and procedures necessary to run an incentive-based compensation program for these two groups, modifications would likely be necessary to ensure full compliance.

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97 75 FR at 36405.

98 BCBS Consultative paper: Range of Methodologies for Risk and Performance Alignment of Remuneration, available at http://www.bis.org/publ/bcbs178.pdf.

99 SEC regulation 17 CFR 229.402(a)(2) requires listed companies to disclose all elements of the compensation provided to "named executive officers" and "directors."

Larger institutions, defined as having total consolidated assets of $50 billion or more, would have to defer at least 50 percent of the annual incentive-based compensation of executive officers for at least three years. These institutions would also apply special review and approval requirements for the incentive-based compensation arrangements for material risk takers. Among OTS-supervised institutions, 13 holding companies and 4 thrifts would be subject to this requirement. These 17 institutions would likely need to make changes to their compensation programs, as it appears that none of them currently defers the required percentage of incentive-based compensation for the required amount of time.

Finally, institutions have an ongoing requirement to prepare annual reports and administer their incentive-based compensation program in compliance with the rule. The administration of the program would include calculating the amount of compensation subject to risk-based adjustment (e.g., deferral), calculating the performance metrics upon which incentive compensation are based, ensuring that independent review of compensation awards is conducted, and assessing the effectiveness of risk-based adjustments to incentive-based compensation payouts. As previously mentioned, institutions generally take these actions to comply with existing safety and soundness regulations and guidance.

To assist the public in understanding how OTS's proposed rule (12 CFR part 563h) compares with Federal Banking Agency Guidelines from 1995 (12 CFR part 570, App. A), and the Federal Banking Agency Guidance from 2010 (75 FR 36395), OTS provides the following summary in bullet form:

1. Applicability

- Proposed Rule – Applies to those savings associations and savings and loan holding companies that have total consolidated assets of $1 billion or more and offer incentive-based compensation arrangements to covered persons (§§ 563h.2 and 563h.3).
- 1995 Guidelines – Applies to all savings associations (¶ I.i).
- 2010 Guidance – Applies to all savings associations (p. 36405 n.2).

2. Reports

- Proposed Rule – Requires annual reports to OTS describing the structure of incentive-based compensation arrangements; sets minimum standards for the reports. (§ 563h.4)
- 1995 Guidelines – No comparable provision.
- 2010 Guidance – No comparable provision.

3. Excessive compensation

- Proposed Rule – Prohibits establishing or maintaining any type of incentive-based compensation arrangement, or any feature of any such arrangement, for covered persons that encourages inappropriate risks by providing excessive compensation (§ 563h.5(a)(1)). Sets a standard that an incentive-based compensation arrangement provides excessive compensation when amounts paid are unreasonable or disproportionate to the services performed, taking into consideration seven factors listed in the proposed rule (§ 563h.5(a) (2)).

- 1995 Guidelines – Prohibits excessive compensation as an unsafe and unsound practice. Sets a standard that compensation is excessive when amounts paid are unreasonable or disproportionate to the services performed by taking into consideration seven factors listed in the guidelines. Covers the same categories of persons and lists the same seven factors as the proposed rule. (¶III.A)
- 2010 Guidance – No comparable provision.

4. <u>Material financial loss</u>

<u>Generally; Requirements for all covered financial institutions</u>

- Proposed Rule – Prohibits establishing or maintaining any type of incentive-based compensation arrangement, or any feature of any such arrangement, that encourages inappropriate risks by the covered financial institution, by providing incentive-based compensation to covered persons, either individually or as part of a group of persons who are subject to the same or similar incentive-based compensation arrangements, that could lead to material financial loss to the covered financial institution (§ 563h.5(b)(1)). Specifies that an incentive-based compensation arrangement established or maintained by a covered financial institution for one or more covered persons must meet three criteria listed in the proposed rule (§ 563h.5(b)(2)).
- 1995 Guidelines – Prohibits compensation that could lead to material financial loss as an unsafe and unsound practice (¶ III.B).

- 2010 Guidance – Provides that incentive compensation arrangements, to be consistent with safety and soundness, should meet three criteria (p. 36405). The criteria listed are the same as in the proposed rule.

Specific requirements for covered financial institutions with $50 billion or more in total consolidated assets; Deferral required for executive officers

- Proposed Rule – Specifies that at least 50% of the incentive-based compensation for an executive officer at an institution with total consolidated assets of $50 billion or more must be deferred over a period of no less than three years, with the release of deferred amounts to occur no faster than on a pro rata basis, and with the adjustment of the deferred amount to reflect actual losses or other measures or aspects of performance that are realized or become better known during the deferral period (§ 563h.5(b)(3)(i)).
- 1995 Guidelines – No comparable provision.
- 2010 Guidance – No comparable provision.

Specific requirements for covered financial institutions with $50 billion or more in total consolidated assets; additional requirement for covered persons presenting particular loss exposure

- Proposed Rule – Contains special procedures and restrictions on the incentive-based compensation of covered persons (other than executive officers) who the institution's board identifies as having the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital, or overall risk tolerance (§ 563h.5(b)(3)(ii)).
- 1995 Guidelines – No comparable provision.

- 2010 Guidance – No comparable provision.

5. Policies and procedures

   - Proposed Rule – Sets minimum standards for policies and procedures on incentive compensation (§ 563h.6).
   - 1995 Guidelines – No comparable provision.
   - 2010 Guidance – No comparable provision. But see discussion of other policy and procedure requirements (pp. 36403-05).

6. Evasions

   - Proposed Rule – Anti-evasion provision prohibits, doing indirectly or through or by any other person, any act or thing that would be unlawful to do directly (§ 563h.7).
   - 1995 Guidelines – No comparable provision.
   - 2010 Guidance – No comparable provision.

Assessment of Impact of Proposed Rule

OTS believes that an institution would spend several hundred person hours conducting an initial review of its incentive-based compensation program and making any necessary modifications. All institutions of $1 billion in total consolidated assets or more would have to conduct the review, and most institutions would have to make some modification to their incentive-based compensation programs.

OTS estimates that smaller institutions (those with less than $50 billion in assets) would spend, at most, eight weeks (320 person hours) to perform the initial steps necessary to comply. Among the covered financial institutions, 146 fall into this category. Using $150 as an estimate of hourly cost,[100] the total cost to the smaller

[100] OTS estimates that legal and administrative expenses would average, at most, $150 per hour.

institutions as a group would be $7 million ($150 x 320 hours x 146 institutions). At larger institutions, these modifications would be more extensive because of the number of individuals involved and the amount the institution would have to expand and/or adjust risk sensitivity measures. The larger institutions may require as much as twice the time as smaller institutions to implement the rule, for an estimated cost of $1.6 million ($150 x 640 hours x 17 institutions). The total initial implementation costs, therefore, should come to approximately $8.6 million.

The subsequent ongoing costs associated with monitoring and managing incentive-based compensation programs, once established, are unlikely to be significantly greater than the costs associated with the administration of current incentive-based programs. OTS, therefore, believes that the ongoing annual costs of the rule would not exceed $100 million. As previously discussed, institutions already have in place most of the mechanisms necessary to implement the rule's requirements. Once the institution makes adjustments indicated by its initial analysis, these mechanisms would continue to function as they do now.

Any ongoing costs in addition to those already incurred would be for:

1. Production of an annual report;

2. Administration of incentive-based compensation for a broader range of employees;

3. Administration of a more complex deferral scheme at some institutions; and

4. More sophisticated risk sensitivity mechanisms.

With respect to item 1, OTS believes that the costs of the annual report would be minimal. Reports after the first submitted would only need to document significant changes to the incentive-based compensation program. Human resource departments maintain descriptions of their incentive-based compensation programs for internal administrative purposes; these descriptions could serve as the basis for regulatory reporting.

With respect to items 2, 3, and 4, OTS anticipates that institutions would use some additional human resources and risk management expertise to administer the programs. For the 17 larger institutions, OTS estimates that the cost of these additional resources would be about $24,000 per institution annually. For the 146 smaller institutions, the additional resources would entail additional personnel and other expenses of less than $12,000 per institution per year.[101] Therefore, OTS estimates the annual cost to be about $2.2 million (17 larger institutions x $24,000 = $0.4 million; 146 smaller institutions x $12,000 = $1.8 million).

In summary, OTS estimates the costs to the institutions of implementing the rule as proposed as follow:

First year: $8.6 million + $2.2 million = $10.8 million.

Second and subsequent years: $2.2 million.

Beyond the costs of implementation, OTS assumes that the broader economic impact of the rule would be negligible. The overall level of compensation, as set by the forces of supply and demand in the labor market, is unlikely to change. Any variations in compensation levels that may occur would be minimal and, given the small number of covered financial institutions, have no effect on overall demand in the economy.

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[101] OTS estimates that for institutions with assets between $1billion and $50 billion, the costs of managing the additional elements of the program would entail some personnel and Information Technology (IT) support. As institutions already have personnel management software systems in place, either in house or contracted out, the incremental costs of IT support would be negligible.

If the rule has its desired effect, institutions will take a more measured approach in their assessment of risk and return. As a result, the amount of lending in some excessively risky business areas may be reduced, which in turn may have an economic impact on the areas served by the 163 OTS-supervised covered financial institutions. Incentive-based compensation programs that appropriately balance risk and reward will entail reductions only of economic activity that is unsound and which, ultimately, entails more cost than benefit to the economy as a whole. Any reduction in inappropriately risky lending brought about by the rule, therefore, would be a benefit of the rule.

The recent crisis in financial markets demonstrated the significant costs that can arise from financial instability; the purpose of the rule is to enhance the financial stability of the financial sector by diminishing incentives for inappropriate risk taking. Because the benefits of financial stability are largely intangible, OTS made no attempt to quantify them here.

Conclusion

OTS's preliminary estimates of the annualized cost of this rule to the 163 OTS-supervised covered financial institutions as a group would be substantially less than $100 million. Moreover, the overall annual economic impact would not be significant. OTS seeks comment on this economic impact assessment.

D. OCC Unfunded Mandates Reform Act of 1995 Determination

Section 202 of the Unfunded Mandates Reform Act of 1995 (2 U.S.C. 1532), requires the OCC to prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in the expenditure by State, local, and tribal governments, in the aggregate, or by the private sector, of $100 million or more in any one year (adjusted annually for inflation). OCC has determined that this proposed rule will not result in expenditures by State, local, and tribal governments, or the private sector, of $100 million or more in any one year. Accordingly, OCC has not prepared a budgetary impact statement.

E. OTS Unfunded Mandates Reform Act of 1995 Determination

Section 202 of the Unfunded Mandates Reform Act of 1995, Pub. L. 104–4 (Unfunded Mandates Act) requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in expenditure by State, local, and tribal governments, in the aggregate, or by the private sector, of $100 million or more (adjusted annually for inflation) in any one year. (The inflation adjusted threshold for 2011 is $142 million or more.) If a budgetary impact statement is required, section 205 of the Unfunded Mandates Act also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule.

OTS has determined that this proposed rule will not result in expenditures by State, local, and tribal governments, or the private sector, in excess of the threshold. Accordingly, OTS has not prepared a budgetary impact statement.

F. NCUA Executive Order 13132 Determination

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their actions on state and local interests. In adherence to fundamental federalism principles, the NCUA, an independent regulatory agency as defined in 44 U.S.C. 3502(5) voluntarily complies with the Executive Order. The Proposed Rule applies to credit unions with $1 billion in assets and over and would not have substantial direct effects on the states, on the connection between the national government and the states, or on the distribution of power and responsibilities among the various levels of government. The NCUA has determined that the Proposed Rule does not constitute a policy that has federalism implications for purposes of the Executive Order.

G. NCUA and FDIC: The Treasury and General Government Appropriations Act, 1999-Assessment of Federal Regulations and Policies on Families

The NCUA and FDIC have determined that this Proposed Rule would not affect family well-being within the meaning of section 654 of the Treasury and General Government Appropriations Act, 1999, Pub. L. 105-277, 112 Stat. 2681 (1998).

H. SEC Economic Analysis

ECONOMIC ANALYSIS

As discussed above, 12 U.S.C. 5641 requires the Commission, jointly with other appropriate federal regulators, to prescribe regulations or guidelines to require covered financial institutions to disclose information about their incentive-based compensation arrangements sufficient for the Agencies to determine whether their compensation structure provides an executive officer, employee, director or principal shareholder with excessive compensation, fees or benefits or could lead to material financial loss to the firm.[102] 12 U.S.C. 5641 also requires the Agencies to prescribe joint regulations or guidelines that prohibit any type of incentive-based compensation arrangements that the Agencies determine encourages inappropriate risks by covered financial institutions by providing excessive compensation to officers, employees, directors, or principal

[102] 12 U.S.C. 5641(a).

shareholders ("covered persons") or that could lead to material financial loss to the covered financial institution.[103]

The Agencies have determined that it is appropriate to propose rules, instead of guidelines, as permitted under 12 U.S.C. 5641. The Commission believes that broker-dealers and investment advisers would benefit from the greater predictability afforded by rules. Such greater predictability would facilitate broker-dealers' and investment advisers' ability to design compliance policies and procedures. The rule being proposed by the Agencies consists of a reporting section, a prohibition section, and a policies and procedures section. The reporting section requires enhanced reporting of incentive-based compensation arrangements for covered persons by a covered financial institution to such institution's appropriate federal regulator. The prohibition section forbids incentive-based compensation arrangements that encourage covered persons to expose the institution to inappropriate risks by providing the covered person excessive compensation and prohibits incentive-based compensation arrangements that encourage covered persons to expose the covered financial institutions to inappropriate risks that could lead to a material financial loss. The policies and procedures section requires that the covered financial institutions maintain policies and procedures to ensure compliance with these requirements and prohibitions. The Commission is sensitive to the costs and benefits imposed on broker-dealers registered with the Commission under section 15 of the Securities Exchange Act ("registered broker-dealers") and investment advisers, as defined in section 202(a)(11) of the Investment Advisers Act of 1940 ("investment advisers"). The discussion below focuses on the costs and benefits applicable to

[103] 12 U.S.C. 5641(b).

registered broker-dealers and investment advisers that meet the definition of "covered financial institution" under the proposed rule (collectively "covered BDs and IAs"). The discussion addresses the decisions made jointly by the Agencies to fulfill the mandates of the Dodd-Frank Act within the Agencies' permitted discretion, rather than the costs and benefits of the mandates of the Dodd-Frank-Act itself. However, to the extent that the Commission's discretion is exercised to realize the benefits intended by the Dodd-Frank Act or to impose the costs associated with the Dodd-Frank Act, the two types of benefits and costs are not entirely separable. Therefore, the Paperwork Reduction Act ("PRA") hourly burden estimates made in accordance with the requirements of the PRA, and their corresponding dollar cost estimates, are included in the calculations below.

A. Report of Incentive-Based Compensation Arrangements

In order to fulfill the requirement imposed by 12 U.S.C. 5641(a) relating to the disclosure of incentive-based compensation arrangements, the proposal would require a covered financial institution to submit a report annually to, and in the format directed by, its regulator, that describes the structure of the covered financial institution's incentive-based compensation arrangements for covered persons. Similar to the policies and procedures requirements under the proposed rule, the annual report would be commensurate with the size and complexity of the organization, as well as the scope and nature of its use of incentive-based compensation arrangements. As such, institutions with no incentive-based compensation arrangements or arrangements that affect only a few covered persons, would need to submit only limited information. The report would be required to contain:

- a clear narrative description of the components of the covered financial institution's incentive-based compensation arrangements applicable to covered persons, specifying the categories of covered persons to which they apply;
- a succinct description of the covered financial institution's policies and procedures governing its incentive-based compensation arrangements;
- for covered financial institutions with total consolidated assets of at least $50 billion, an additional succinct description of incentive-based compensation policies and procedures specific to the covered financial institution's executive officers and other covered persons who the institution's board of directors (or a committee of the board) has identified and determined have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital, or overall risk tolerance;
- a description of any material changes to the covered financial institution's incentive-based compensation arrangements and policies and procedures made since the covered financial institution's last report submitted this section; and
- the specific reasons the covered financial institution believes the structure of its incentive-based compensation arrangements does not provide covered persons incentives to engage in behavior that is likely to cause the covered financial institution to suffer a material financial loss and does not provide covered persons with excessive compensation.

1. <u>Benefits</u>

The Commission believes that the information that would be required to be reported to the Commission under proposed § 248.205 would assist Commission examiners to determine whether covered BDs and IAs are fulfilling the requirements of section 956 of the Dodd-Frank Act. The report is designed to elicit pointed, succinct explanations about issues that would likely be of high interest to an examiner, such as a clear narrative description of the firm's incentive-based compensation plan, a succinct description of the firm's incentive-based compensation policies and procedures and any changes thereto, and reasons that the compensation structure will not encourage behavior that violates the principles of 12 U.S.C. 5641. The Commission anticipates that examiners would find these descriptions a useful starting point in an examination to make a risk-assessment as to which areas of a firm's incentive-based compensation arrangements merit further examination. Persons within covered BDs and IAs responsible for determining compensation levels, as well as persons receiving incentive-based compensation would be able to review the incentive-based compensation policies, which should promote the balance of the incentive-based compensation process at covered BDs and IAs. The Commission also believes that the reporting of incentive-based compensation information would foster a climate of accountability at covered BDs and IAs by raising the profile of incentive-based compensation at firms, and thereby improving the care with which the firms design their incentive-based compensation programs. By including persons who individually have the ability to expose a firm with total consolidated assets of at least $50 billion to possible losses that are substantial in relation to the firm's size, capital, or overall risk tolerance as persons whose compensation should be subject to the requirements of the statute (designated risk takers), the proposed rule should encourage executives to consider more carefully those compensation arrangements that could potentially lead to activities that could expose the covered institution to significant risks. Properly incentivizing designated risk takers could limit the risk exposure of covered financial institutions.

The reporting provisions of the proposed rule are designed to elicit qualitative statements from the covered financial institution, including covered BDs and IAs, regarding, among other things, the specific reasons the covered financial institution believes the structure of its incentive-based compensation plan does not provide covered persons incentives to engage in behavior that is likely to cause the covered financial institution to suffer a material financial loss and does not provide covered persons with excessive compensation. The proposed rule is designed to elicit a meaningful discussion of the firm's incentive-based compensation arrangements. In all cases, covered BDs and IAs should report to the Commission the comprehensive descriptions relating to each of the required disclosures described below.

2. Costs

The Commission is aware that requiring companies to file reports on the structure of their incentive-based compensation arrangements could impose costs on covered financial institutions. For example, by requiring covered financial institutions to report the information in the proposed rule, it is possible that this could serve as a disincentive for covered financial institutions to re-visit or otherwise revise their incentive-based compensation plans, because doing so would create additional regulatory burdens for the covered financial institution. Further, while the Commission intends to keep the reported information confidential to the full extent it is permitted to do so under the Freedom of Information Act ("FOIA"), the Commission understands that firms may nonetheless have concerns about potential disclosure of information that could be competitively sensitive, as incentive-based compensation plans and arrangements are. The Commission believes that not including information regarding the individual compensation levels of covered persons may mitigate some confidentiality concerns. Accordingly, the Commission is aware of these potential costs and seeks comment on them generally, as well as on any specific methods that could be used to minimize these costs and concerns.

The Commission is also aware that the proposed rule would generate compliance-related costs associated with, among other things, collecting the necessary information and preparing the reports, as well as hiring outside professionals, such as attorneys, compensation or benefits consultants, accountants and/or actuaries. In the charts below, the Commission estimates the internal and external costs associated with the proposed reporting requirements. In order to arrive at the internal cost estimates, the Commission multiplied the hourly burden estimates provided in the PRA Section by the estimated hourly rate for a securities attorney.[104] The Commission is using the same external cost estimates for the reporting requirement that it used in the PRA Section of this proposed rule. The Commission seeks comment on all these cost estimates.

Internal Costs

	Covered bank BDs and IAs ($50B +)	Covered bank BDs and IAs ($1B-$50B)	Covered non-bank BDs and IAs ($50B +)	Covered non-bank BDs and IAs ($1B-$50B)
Initial Reporting	$900,000[105]	$3 million[106]	$175,000[107]	$3 million[108]

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104 The Commission estimates $354 per hour for a securities attorney, based on SIFMA's *Management & Professional Earnings in the Securities Industry 2010,* modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

105 2,500 hours x $354/hour = $885,000

106 8,500 hours x $354/hour = $3,009,000

107 500 hours x $354 = $177,000

108 8,500 hours x $354/hour = $3,009,000

Ongoing Reporting	$900,000[109]	$3 million[110]	$175,000[111]	$3 million[112]

External Costs

	Covered bank BDs and IAs ($50B +)	Covered bank BDs and IAs ($1B-$50B)	Covered non-bank BDs and IAs ($50B +)	Covered non-bank BDs and IAs ($1B-$50B)
Initial Reporting	$1 million[113]	$3.4 million[114]	$200,000[115]	$3.4 million[116]
Ongoing Reporting	$1 million[117]	$3.4 million[118]	$200,000[119]	$3.4 million[120]

B. Prohibition on Certain Incentive-Based Compensation Arrangements

The proposed rule states that a covered financial institution may not establish or maintain any incentive-based compensation arrangement, or any feature of any such arrangement, that encourages a covered person to expose the institution to inappropriate risks by providing that person with excessive compensation. Under the proposed rule,

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109 2,500 hours x $354/hour = $885,000

110 8,500 hours x $354/hour = $3,009,000

111 500 hours x $354 = $177,000

112 8,500 hours x $354/hour = $3,009,000

113 2,500 hours x [(25% x $400/hour) + (25% x $600/hour) + (25% x $330/hour) + (25% x $250/hour)] = $987,500

114 8,500 hours x [(25% x $400/hour) + (25% x $600/hour) + (25% x $330/hour) + (25% x $250/hour)] = $3,357,500

115 500 hours x [(25% x $400/hour) + (25% x $600/hour) + (25% x $330/hour) + (25% x $250/hour)] = $197,500

116 8,500 hours x [(25% x $400/hour) + (25% x $600/hour) + (25% x $330/hour) + (25% x $250/hour)] = $3,357,500

117 2,500 hours x [(25% x $400/hour) + (25% x $600/hour) + (25% x $330/hour) + (25% x $250/hour)] = $987,500

118 8,500 hours x [(25% x $400/hour) + (25% x $600/hour) + (25% x $330/hour) + (25% x $250/hour)] = $3,357,500

119 500 hours x [(25% x $400/hour) + (25% x $600/hour) + (25% x $330/hour) + (25% x $250/hour)] = $197,500

120 8,500 hours x [(25% x $400/hour) + (25% x $600/hour) + (25% x $330/hour) + (25% x $250/hour)] = $3,357,500

compensation would be considered excessive when amounts paid are unreasonable or disproportionate to the services performed by a covered person. In determining whether incentive-based compensation is unreasonable or disproportionate to the services performed, the covered BDs and IAs would consider those factors set forth in the section 39(c) of the FDIA.[121]

To address the prohibition against arrangements that potentially encourage inappropriate risks that could lead to a material financial loss at the covered financial institution, the Agencies propose to deem incentive-based compensation arrangements for all covered persons to encourage inappropriate risks that could lead to material financial loss at the institution unless the arrangement or feature: (i) balances risk and financial results, for example, by using deferral of payments, risk adjustment of awards, longer performance periods, or reduced sensitivity to short-term performance; (ii) is compatible with effective controls and risk management; and (iii) is supported by strong oversight by

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[121] Under Section 248.205(a)(2) of the proposed rule, an incentive-based compensation arrangement provides excessive compensation when amounts paid are unreasonable or disproportionate to the services performed by a covered person, taking into consideration:

(i) The combined value of all cash and non-cash benefits provided to the covered person;
(ii) The compensation history of the covered person and other individuals with comparable expertise at the covered financial institution;
(iii) The financial condition of the covered financial institution;
(iv) Comparable compensation practices at comparable institutions, based upon such factors as asset size, geographic location, and the complexity of the institution's operations and assets;
(v) For postemployment benefits, the projected total cost and benefit to the covered financial institution;
(vi) Any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the covered financial institution; and
(vii) Any other factors the Commission determines to be relevant.

a covered BD's or IA's board of directors. These principles are substantially identical to the principles published in the Guidance.[122]

The proposed rule would require additional measures for certain covered persons working for covered financial institutions with total consolidated assets of $50 billion or more. For executive officers and heads of major business lines of such firms, at least 50% of their incentive-based compensation would be required to be deferred on a pro-rata basis over a period of at least three years. Such executive officers' and business line heads' deferred incentive-based compensation would be required to be adjusted downward to reflect actual losses or other measures or aspects of performance that are realized or become better known during the deferral period (the "look-back").

The Agencies also propose for a covered financial institution with $50 billion or more in assets that for certain classes of covered person whose activities, by their nature, expose the covered financial institution to a risk of significant loss (designated risk takers), that such firm's board of directors, or a committee thereof, perform individual review of each such person's incentive-based compensation against certain factors and that each such person's incentive-based compensation be approved by the board of directors, or committee thereof.

1. Benefits

The Commission believes that the proposed prohibitions related to the incentive-based compensation arrangements would help ensure that covered financial institutions avoid incentive-based compensation arrangements that would threaten the safety and soundness of the covered financial institution or otherwise have serious adverse effects

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122 See Guidance on Sound Incentive Compensation Policies, 75 FR 36395 (June 25, 2010) (jointly adopted by the OCC, the FRB, the FDIC and OTS).

on economic conditions or financial stability of covered BDs and IAs. In order to address the adverse effects that incentive-based compensation arrangements may have on covered financial institutions' financial condition, the proposed rules would mandate the application of the principles described in the Guidance (provide incentives that appropriately balance risk and reward, compatibility with effective controls and risk-management, and the support of strong corporate governance) to all covered financial institutions, including covered BDs and IAs. The Commission believes that applying these principles to covered BDs and IAs should promote sound incentive-based compensation practices and discourage incentive-based compensation arrangements that contributed to the recent financial crisis.

The proposed elements defining when an incentive-based compensation arrangement provides excessive compensation or could result in a material financial loss would benefit covered financial institutions by identifying specific factors to determine whether certain arrangements are prohibited. Abiding by the standards reflected in section 39(c) of the FDIA and the principles described in the Guidance, which already apply to banking institutions, should help to promote the safety and soundness of the covered BD or IA and by extension protect investors and promote the public interest. The proposed rule also should give firms the discretion to reward the most productive employees because the definition of "excessive compensation" should be sufficiently broad so as to permit covered financial institutions the flexibility to reward productive employees.

Moreover, by not prescribing mandatory deferral for covered BDs and IAs with assets under $50 billion, but rather by requiring non-specific standards for these arrangements (i.e., that they balance risk and return, are compatible with effective controls and risk management, etc.), the proposed rule would provide smaller covered BDs and IAs with significant flexibility to tailor their compensation packages to their covered persons. The proposed rule would permit covered BDs and IAs with assets below $50 billion to determine their respective incentive-based compensation arrangements within the parameters of meeting certain goals (i.e., that the payments balance risk and return, are compatible with effective risk controls and risk management) set forth in the proposed rule.

The Commission believes that the proposed rule should curb excessive risk taking, which should lead to more effective capital allocation. The rule should discourage compensation incentives that encouraged capital flow into investments that were unprofitable on the whole. Hereafter, the flow of capital into less risky investments should result in capital being put to more effective use. More efficient capital allocation, in turn, should improve the quality of the firms' financial services and products, as firms employ capital to its most productive use. Since higher quality service and products are ordinarily associated with increased competition, it is possible that competition among covered BDs and IAs would be more robust.

By requiring that the incentive-based compensation arrangements of covered BDs and IAs with more than $50 billion in total assets defer at least 50% of the compensation of covered executives and chiefs of major business lines for at least three years, and requiring firms to adjust any amount deferred to reflect actual losses or other measures of performance that are realized or become better known only during the deferral period, the proposed rule should help align the interests of those covered persons with the greatest ability to influence the risk profile of the covered financial institution with the interests of the covered financial institution. The deferral requirement for executive officers and chiefs of major business lines at the largest covered financial institutions reflects the previously acknowledged benefit for deferral of certain high-level employees whose activities present broad, and potentially lengthy, risk exposure to an institution, and whose activities do not lend themselves as easily to risk quantification and assessment through ex ante or other predictive risk adjustment measures. Requiring deferral for this discrete group of individuals at particularly large institutions, where up-front or ex ante risk adjustment measures are less likely to be effective, is a useful risk adjustment tool. It permits time for risks not previously discerned or quantifiable to ultimately materialize and permits adjustment of unreleased deferral payments on the basis of observed consequences as opposed to mere predicted results. The Commission believes that the heightened standards for the largest covered BDs and IAs is particularly appropriate because decisions made at the largest covered BDs and IAs can greatly impact the fair and orderly operation of the financial markets. These deferral restrictions should weaken the incentive for executive officers and chiefs of major business lines to make decisions that create short term gain at the expense of increased long term risk. The Commission also expects that by example, an express deferral requirement for executive officers and heads of major business lines would have a broader beneficial impact on the structure of compensation used throughout a company.[123] The required look-back mechanism included in the proposed rule is a means by which the covered

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123 Certain recent studies provide empirical evidence consistent with deferred compensation helping reduce the probability of corporate default. See e.g. Wei and Yermack (2010). In one study, the authors conclude that bank CEOs with large amounts of inside debt in the form of pensions and deferred compensation exposed their firms to less risk and obtained greater performance during the recent financial crisis. (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1519252).

financial institution may reduce previously awarded compensation over the deferred period of time. Thus, the required look-back adds to the power of deferring compensation in that previously awarded compensation may actually not be awarded if the firm finds that such compensation does not reflect actual losses or other measures better realized during the deferral period.

As with the deferral requirement and the look-back mechanism, the Commission preliminarily believes that these provisions of the proposed rule relating to designated risk takers would help to strengthen board oversight of covered persons' incentive-based compensation. The Commission believes that promoting strong corporate governance oversight of a covered BD's or IA's incentive-based compensation arrangements would promote sound practices and foster a high quality process regarding incentive-based compensation decisions at a covered financial institution. Moreover, the additional oversight of designated risk takers' incentive-based compensation should help to provide proper incentives to these persons and thus limit the risk exposure of covered BDs and IAs. In addition, requiring the board of directors, or a committee of the board, to identify designated risk takers other than executive officers and to approve their incentive-based compensation should help to improve the board's understanding of the risk profile of certain firm activities or divisions that have the ability to expose the institution to possible substantial losses. It would also encourage the board to spend more time considering the compensation arrangements of important employees who are not executives but who have the ability to materially impact the risk profile of the firm. The proposed rule also provides covered financial institutions the flexibility to determine who the relevant potential excessive risk takers are.

2. <u>Costs</u>

a. <u>All Covered BDs and IAs</u>

The Commission also anticipates that the proposed rule may entail certain costs. For example, in a case where a firm elects to defer an excessive portion of covered persons' compensation, such deferral may reduce effort expended by covered persons and the willingness of covered persons to take even measured risks. The Commission understands that it is necessary for covered financial institutions to take a certain amount of risk in order to operate their businesses. Accordingly, the Commission desires to carefully balance the need for covered financial institutions to take risk against the possibility that if the wrong regulatory balance is struck, covered persons may have the incentive to actually take less risk than is optimal in order to ensure that, on a personal level, the covered employee has sufficient cash flow. In the event that employees are induced to take less than optimal risk, then there might be a negative effect on the efficiency of capital allocation. The Commission preliminarily believes that the proposed rule strikes an appropriate balance in this regard but requests comment generally on this issue.

Based on its experience in the area, staff conversations with covered BDs and filings by publicly-traded covered BDs, IAs and certain parent companies, the Commission believes that the elements of the prohibition applicable to all covered BDs and IAs related to excessive compensation and material financial loss to the firms already generally represent the practices of many covered BDs and IAs. Therefore, the Commission believes that covered BDs and IAs generally already consider factors consistent with those referenced in section 39(c) of the FDIA and the principles in the

Guidance in designing and administering their incentive-based compensation programs. Nonetheless, the Commission recognizes that some covered BDs and IAs may not conform to incentive-based compensation standards consistent with section 39(c) of the FDIA and the principles in the Guidance.

In addition, the Commission acknowledges the possibility that the proposed rules may reduce the incentive for certain covered persons to switch jobs because would-be new employers that are covered financial institutions would be bound to offer such covered persons compensation packages that comply with the proposed rules. If a lack of turnover results, it might adversely impact competitiveness among firms, but it may also promote institutional stability within firms. The Commission believes the proposed rule strikes an appropriate balance in this regard, but requests comment generally on this issue.

The Commission seeks comment on whether the proposed prohibitions applicable to covered BDs and IAs (which include only those broker-dealers and investment advisers with assets of more than $1 billion) may disadvantage covered financial institutions as compared to financial institutions not covered under the proposed rules because covered financial institutions would be required to assume costs in designing, implementing, monitoring and maintaining a regulatory program reasonably designed to address the requirements of the proposed rules, whereas broker-dealers and investment advisers with total consolidated assets less than $1 billion would not be subject to such costs. The Commission also seeks comment on whether it is possible that covered BDs and IAs would have more difficulty recruiting qualified individuals to work for their firms if such individuals fear that added scrutiny of their incentive-based compensation may lead to lower aggregate pay.

b. Covered BDs and IAs with Assets of $50 Billion or More

In addition to the costs imposed upon all covered BDs and IAs, described above, the proposed rule would impose additional costs on firms with assets of $50 billion or more. The Commission anticipates that it is possible that covered BDs and IAs with assets of $50 billion or more may have to pay more in base salary to compensate their executive officers and heads of a major business line for the uncertainty associated with the ultimate receipt of deferred compensation. However, it is also possible that increases in salaries would be offset by decreases in deferred incentive-based compensation. The Commission requests comment on whether covered BDs and IAs should expect to incur the cost of increased salaries that may result from the implementation of required deferred compensation and look-back policies for certain covered persons.

As stated above, the Commission also recognizes that the firms with assets of at least $50 billion may have more difficulty recruiting individuals for those positions than a firm not subject to the deferral requirement. In addition, such firms may have difficulty recruiting individuals who object to having their compensation specifically approved and monitored by the covered BD's or IA's board of directors or committee thereof. To the extent that this adversely affects the quality of employees that firms of that size are able to attract, it may negatively affect the business of larger covered financial institutions.

To the extent that the proposal relies on an assumption that a covered person understands the risks inherent in a particular business decision but chooses to disregard them because the covered person would not bear the costs associated with those risks being realized, the proposal may not be effective at promoting a more accurate or realistic assessment of a business decision as to which neither the executive officer nor the covered financial institution grasps the inherent risk. To the extent, however, that the proposal relies on an assumption that covered persons do not always fully understand the risks inherent in particular business decisions and have had inadequate incentives to ensure that they comprehend these risks, the proposal would be more effective. It is not clear what, if any, other regulatory steps could be taken to promote a better comprehension of risk, and mandatory deferral as provided in the proposed rule would at least provide some required measure of risk adjustment in cases where such risks are understood by executive officers at large covered financial institutions. If, however, the risks that covered persons take are very long term (i.e., beyond 5 years), the proposed compensation deferral might not prove to be effective at deferring covered persons' taking on inappropriate risk for the firm.

As stated above, the Commission also believes there would be compliance-related costs associated with the proposed rule. Based upon experience of the Commission staff, the Commission understands that although mandatory deferral of a significant percentage of firms' incentive-based compensation to executive officers and chiefs of major business lines is the existing practice among many covered BDs and IAs, it would represent a new practice for some firms. Even for firms with existing deferral practices, there would be costs to conform their deferral practices to the requirements of proposed § 248.205(b)(3). For example, based on staff's discussions with the industry, its review of information in public filings, and its experience in the area, the Commission believes that the practice of adjusting deferred amounts of compensation to reflect actual losses or other measures that are realized or become known during the deferral period (administering a look-back) exists in comparatively fewer firms than does the practice of deferral itself. The Commission also believes that many firms may provide deferral or vesting periods of less than the three years under the proposed rule. The Commission believes, based upon its experience and the filings submitted by publicly-traded covered BDs, IAs and certain public companies, that some, but not all boards or board committees of covered BDs and IAs with assets of at least $50 billion already have a role in approving the compensation for highly-paid individuals, including most people that would be defined as designated risk takers under the proposed rule. Accordingly, the Commission anticipates that covered BDs and IAs would experience costs in implementing the deferral, look-back and designated risk takers components of the requirements for firms with assets of $50 billion or more.

The requirement under proposed § 248.205(b)(3)(ii)(B) to require the board of directors (or committee of the board) of covered financial institutions that have total consolidated assets of $50 billion or more to approve and document the identification of those covered persons that individually have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital, or overall risk tolerance would create new burden for such larger covered financial institutions. Based on staff experience and conversations with larger covered BDs and the filings submitted by publicly-traded covered IAs and certain parent companies, the Commission does not believe that the boards of larger covered BDs and IAs generally identify and approve the compensation of such designated risk takers.

The Commission believes that the most significant ongoing cost that covered BDs and IAs would assume to comply with proposed § 248.205(b)(3)(ii)(B) is the cost of having appropriate senior personnel administer the deferred compensation, look-back and designated risk takers provisions. As with all matters related to incentive-based compensation, covered BDs and IAs would be required to administer their incentive-based compensation arrangements in a manner that is compatible with effective controls and risk management and is supported by strong corporate governance, including active and effective oversight by the covered financial institution's board of directors. The Commission anticipates that firms would use an appropriate mix of senior risk management personnel along with the firms' board of directors, or committee thereof, to administer the identification of designated risk takers and approval of their compensation, as required under the proposed rule.

Larger covered financial institutions with total consolidated assets of at least $50 billion may experience a disadvantage relative to smaller financial institutions on account of the proposed required deferral for executive officers and board-level review of the incentive-based compensation of designated risk takers. In addition to the added costs that such larger financial institutions would incur to implement the deferral and board-level review of designated risk takers' compensation, the Commission believes that some executive officers may have disincentives from working for a covered financial institution whereby their compensation would be required to be deferred or in firms where their incentive-based compensation is subject to board-level scrutiny.

In order to help the Commission better understand all the costs associated with this aspect of the proposed rule, the Commission requests comment on them generally. The Commission is also soliciting comment on the following specific issues:

- Do commenters believe that requiring a minimum deferral period of three years for at least 50% of the compensation for executive officers and chiefs of major business lines at large covered financial institutions would place such financial institutions at an unjustified disadvantage in the hiring of and retaining qualified personnel as compared to smaller covered financial institutions? If commenters believe that this is the case, what would commenters do to modify the proposed rule while reasonably ensuring that there is useful and meaningful risk adjustment of incentive-based compensation for executives at large covered financial institutions? Do commenters believe that requiring a different minimum deferral period or minimum deferred percentage would promote better incentive-based compensation practices? Should the required minimum deferral provisions be extended to smaller covered financial institutions?
- Do commenters believe that there is a substantial risk that covered financial institutions would reconfigure their operations, structure, or assets in such a manner so as to circumvent being classified as a large covered financial institution?
- Do commenters believe that mandating deferral as a risk adjustment tool for executive officers at large covered financial institutions would inhibit the development of other potentially more effective risk adjustment tools? Are there

other risk adjustment tools that are more effective than deferral, and why are those tools more effective?

C. Required Policies and Procedures and Documentation of the Compensation of Certain Covered Persons

The proposal would require covered financial institutions to adopt policies and procedures reasonably designed to ensure and monitor compliance with 12 U.S.C. 5641 commensurate with the size and complexity of the organization and the scope and nature of its use of incentive-based compensation. As described in further detail above, the proposed rule would require that the policies and procedures, at a minimum, be consistent with the disclosure requirements and prohibitions in other parts of the proposed rule, ensure that risk management or oversight personnel have a role in designing and assessing incentive-based compensation arrangements, provide for independent monitoring of the incentive-based compensation awards, risks taken and actual outcomes, require that a covered financial institution's board receive data and an analysis to enable the board to assess whether the incentive-based compensation arrangements are consistent with 12 U.S.C. 5641, and require sufficient documentation of the covered financial institution's incentive-based compensation arrangements to enable the Commission to determine the covered BDs' or IAs' compliance with 12 U.S.C. 5641. In addition, the proposal would require that the covered BDs' and IAs' policies and procedures include certain features for when a firm uses deferral in connection with an incentive-based compensation arrangement, and that the policies and procedures subject incentive-based compensation arrangements to an appropriate corporate governance framework.

In addition, for covered BDs and IAs with assets of at least $50 billion, proposed § 248.205(b)(3)(ii)(B) would require a firm's board of directors, or a committee thereof, to identify those covered persons (other than executive officers) that individually have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital, or overall risk tolerance These covered persons may include, for example, traders with large position limits relative to the institution's overall risk tolerance and other individuals that have the authority to place at risk a substantial part of the capital of the covered financial institution. The Agencies propose that the compensation decisions applicable to such persons must be approved by the firm's board of directors or a committee of the board and that the covered BD or IA document the compensation decisions made by the board or its committee.

1. Benefits

The Commission believes that requiring covered financial institutions to adopt and enforce the policies and procedures described above would foster the Agencies' understanding of the covered financial institutions' incentive-based compensation practices and would promote compliance and accountability regarding the practices that the Agencies propose to prohibit. The rule is designed to ensure that covered BDs and IAs establish adequate procedures and controls to ensure compliance with 12 U.S.C 5641. The Commission preliminarily believes that the policies and procedures section of the proposed rule would help to ensure that boards receive data to monitor incentive-based compensation arrangements. Further, the Commission believes that, at a minimum, the proposed rule should help to ensure that incentive-based compensation arrangements would be designed with more careful consideration of its effects on risk.

The Commission also believes that the proposed rule would provide greater board of director and risk management / risk oversight personnel supervision of incentive-based compensation arrangements and practices at the covered financial institution because boards would receive data and analysis from management to support a finding that the incentive-based compensation arrangements are consistent with 12 U.S.C. 5641. Moreover, risk-management / risk-oversight personnel would help to design and assess the effectiveness of the covered BD's or IA's incentive-based compensation arrangement. The Commission believes that these provisions of the proposed rule would help to strengthen the supervision of covered persons' incentive-based compensation arrangements by the board of directors. The proposed rule would help increase the importance of the compensation-setting function at covered financial institutions, including covered BDs and IAs. The Commission preliminarily believes that this increased internal importance would result in a higher quality process regarding incentive-based compensation decisions at a covered financial institution. For example, the proposed rule would help to ensure that information is received by the relevant decision makers and other persons acting in an internal supervisory role within the covered financial institution. This development should strengthen the supervision of the board with respect to incentive-based compensation arrangements.

The recordkeeping requirement in proposed in § 248.206(b)(5) should ensure that Commission staff members are able to properly examine covered BDs' and IAs' incentive-based compensation practices in the context of an examination. The proposal also would require that a covered BD or IA have policies and procedures that provide that compensation payments are reduced to reflect adverse risk outcomes or high levels of risk taken. This should help ensure that the compensation contracts are accurately followed and diminish the adverse effect of deferred compensation that proves to be unwarranted once the risks associated with the covered person's activities are realized over time.

2. Costs

As described more fully in the PRA Section, the Commission believes that covered individual bank BDs and IAs would be subject to significantly less initial and ongoing costs than non-bank BDs and IAs because bank BDs and IAs are already subject to the Guidance. The Commission is also aware that the proposed rule would generate compliance-related costs associated with, among other things, collecting the necessary information and preparing the reports, as well as hiring outside professionals, such as attorneys, compensation or benefits consultants, accountants and/or actuaries. In the chart below, the Commission estimates the internal costs associated with the proposed recordkeeping requirements. In order to arrive at these internal cost estimates, the Commission multiplied the hourly burden estimates provided in the PRA Section by the estimated hourly rate for a securities attorney.[124] The Commission is using the same external cost estimates for the recordkeeping requirement that it used in the PRA Section of this proposed rule. The Commission seeks comment on all these cost estimates.

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[124] The Commission estimates $354 per hour for a securities attorney, based on SIFMA's Management & Professional Earnings in the Securities Industry 2010, modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

Total Internal Recordkeeping Cost

	Covered bank BDs and IAs ($50B +)	Covered bank BDs and IAs ($1B-$50B)	Covered non-bank BDs and IAs ($50B +)	Covered non-bank BDs and IAs ($1B-$50B)
Initial Recordkeeping	$900,000[125]	$1.2 million[126]	$1.1 million[127]	$16 million[128]
Ongoing Recordkeeping	$400,000[129]	$400,000[130]	$150,000[131]	$1.5 million[132]

Total External Recordkeeping Cost

	Covered bank BDs and IAs ($50B +)	Covered bank BDs and IAs ($1B-$50)	Covered non-bank BDs and IAs ($50B +)	Covered non-bank BDs and IAs ($1B-$50B)
Initial Recordkeeping	$1 million[133]	$1.3 million[134]	$1.2 million[135]	$18 million[136]
Ongoing Recordkeeping	$400,000[137]	$400,000[138]	$250,000[139]	$1.7 million[140]

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125 2,500 hours x $354 = $885,000

126 3,400 hours x $354 = $1,203,600

127 3,000 hours x $354 = $1,062,000

128 46,000 hours x $354 = $16,284,000

129 1,000 hours x $354 = $354,000

130 1,000 hours x $354 = $354,000

131 400 hours x $354 = $141,600

132 4,300 hours x $354 = $1,522,200

133 2,500 hours x [(25% x $400/hour) + (25% x $600/hour) + (25% x $330/hour) + (25% x $250/hour)] = $987,500.

134 3,400 hours x [(25% x $400/hour) + (25% x $600/hour) + (25% x $330/hour) + (25% x $250/hour)] = $1,343,000

135 3,000 hours x [(25% x $400/hour) + (25% x $600/hour) + (25% x $330/hour) + (25% x $250/hour)] = $1,185,000.

136 46,000 hours x [(25% x $400/hour) + (25% x $600/hour) + (25% x $330/hour) +(25% x $250/hour)] = $18,170,000

137 1,000 hours x [(25% x $400/hour) + (25% x $600/hour) + (25% x $330/hour) + (25% x $250/hour)] = $395,000

138 1,000 hours x [(25% x $400/hour) + (25% x $600/hour) + (25% x $330/hour) + (25% x $250/hour)] = $395,000

SOLICITATION OF COMMENT

In enacting this section of the Dodd-Frank Act, Congress has made the judgment that regulation entailing potential burdens and impacts of the type discussed below is justified so as to prevent covered financial institutions from utilizing incentive-based compensation arrangements that could threaten the health of financial institutions or have serious effects on economic conditions or financial stability.[141] The Commission generally solicits comment on all the costs, benefits, and analyses set forth in this economic analysis. The Commission also specifically requests comment on the following issues:

- The Commission requests comments on the anticipated impact of the proposal on the competitiveness of covered financial institutions as compared to broker-dealers and investment advisers that do not meet the definition of covered financial institution as well as the impact of the proposal on the competitiveness of covered BDs and IAs with assets of at least $50 billion as compared to covered BDs and IAs with assets between $1 billion and $50 billion.
- Could the proposed rule be modified so as to implement the mandate of 12 U.S.C. 5641 in a manner that improves the efficiency of covered financial institution and imposes less of a burden on competition? If so, what specific changes would commenters suggest? Would the impact be improved with a different deferral

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139 600 hours X [(25% x $400/hour) + (25% x $600/hour) + (25% x $330/hour) + (25% x $250/hour)] = $237,000

140 4,300 hours x [(25% x $400/hour) + (25% x $600/hour) + (25% x $330/hour) + (25% x $250/hour)] = $1,698,500

141 See Joint Explanatory Statement of the committee of Conference Accompanying H.R. 4173, H.R. Rep. No. 111-517, at 873.

threshold (currently 50% of incentive-based compensation) or deferral period (currently no faster than pro rata over 3 years)? Is there a better way to design or apply the "look-back" period?

- The Commission solicits public comment on the degree to which commenters believe that the proposal would encourage covered employees to take optimal risk and/or discourage covered employees from taking inappropriate levels of risk. If commenters believe the proposal would lead to covered employees undertaking less than optimal risk (e.g., make decisions that are too conservative for the firm), then please elaborate why that is the case.
- If commenters believe a different approach is warranted, do commenters believe that a different approach would be equally effective at helping to ensure, particularly at large covered financial institutions, that incentive-based compensation arrangements do not result in excessive compensation or a material financial loss to the covered financial institution? What alternative would commenters propose and why do commenters believe that it would be as effective, or more effective?
- Does the proposed rule promote greater internal discipline and controls by covered financial institutions with respect to incentive-based compensation arrangements? Similarly, does the proposed rule help to promote that discipline upon a greater number of persons at the covered financial institution, including not only the executive officers (or comparable persons) at a covered financial institution, but also those persons whose activities subject the covered financial institution to significant risk?

I. SEC CONSIDERATION OF IMPACT ON THE ECONOMY

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"[142] the Commission must advise OMB whether a proposed regulation constitutes a major rule. Under SBREFA, a rule is "major" if it has resulted in, or is likely to result in:

- an annual effect on the economy of $100 million or more
- a major increase in costs or prices for consumers or individual industries; or
- a significant adverse effect on competition, investment, or innovation.

If a rule is "major," its effectiveness will generally be delayed for 60 days pending Congressional review. The Commission requests comment on the potential impact of each of the proposed rules and rule amendments on the economy on an annual basis, on the costs or prices for consumers or individual industries, and on competition, investment, or innovation. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

LIST OF SUBJECTS

12 CFR Part 42

> Compensation, Banks, banking, National banks, Reporting and recordkeeping requirements.

12 CFR Part 236

> Compensation, Banks, Bank Holding Companies, Reporting and recordkeeping requirements.

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[142] Pub. L. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

12 CFR Part 372

Banks, Banking, Compensation, Foreign Banking.

12 CFR Part 563h

Compensation, Holding companies, Reporting and recordkeeping requirements, Savings associations.

12 CFR Parts 741 and 751

Compensation, Credit Unions, Reporting and recording requirements.

17 CFR Part 248

Incentive-based Compensation Arrangements, Reporting and recordkeeping requirements; Securities.

Department of the Treasury
Office of the Comptroller of the Currency

12 CFR Chapter I

Authority and Issuance

For the reasons set forth in the joint preamble, the OCC proposes to amend 12 CFR Chapter I of the Code of Federal Regulations as follows:

1. Add part 42 to read as follows:

PART 42 – Incentive-Based Compensation Arrangements

Sec.

42.1 Authority.

42.2 Scope and purpose.

42.3 Definitions.

42.4 Required reports to regulators.

42.5 Prohibitions.

42.6 Policies and procedures.

42.7 Evasion.

Authority: 12 U.S.C. 1 et seq. 1, 93a, and 5641.

§ 42.1 Authority.

This part is issued pursuant to section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. 5641).

§ 42.2 Scope and purpose.

This part applies to a covered financial institution that has total consolidated assets of $1 billion or more and offers incentive-based compensation arrangements to covered persons. Nothing in this part in any way limits the authority of the OCC under other provisions of applicable law and regulations.

§ 42.3 Definitions.

For purposes of this part, the following definitions apply unless otherwise specified:

(a) Board of directors means the governing body of any covered financial institution performing functions similar to a board of directors. For Federal branches and agencies, "board of directors" means parent foreign bank senior management.

(b) Compensation means all direct and indirect payments, fees or benefits, both cash and non-cash, awarded to, granted to, or earned by or for the benefit of, any covered person in exchange for services rendered to the covered financial institution, including, but not limited to, payments or benefits pursuant to an employment contract, compensation or benefit agreement, fee arrangement, perquisite, stock option plan, postemployment benefit, or other compensatory arrangement.

(c) Covered financial institution means a national bank or a Federal branch or agency of a foreign bank that has total consolidated assets of $1 billion or more.

(d) Covered person means any executive officer, employee, director, or principal shareholder of a covered financial institution.

(e) Director of a covered financial institution means a member of the board of directors of the covered financial institution, or of a board or committee performing a similar function to a board of directors.

(f) Executive officer of a covered financial institution means a person who holds the title or, without regard to title, salary, or compensation, performs the function of one or more of the following positions: president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief risk officer, or head of a major business line.

(g) Incentive-based compensation means any variable compensation that serves as an incentive for performance.

(h) Principal shareholder means an individual who directly or indirectly, or acting through or in concert with one or more persons, owns, controls, or has the power to vote 10 percent or more of any class of voting securities of a covered financial institution.

(i) Total consolidated assets means:

(A) For a national bank, calculating the average of the total assets reported in the bank's four most recent Consolidated Reports of Condition and Income ("Call Report"); and

(B) For a Federal branch and agency, calculating the average of the total assets reported in the Federal branch or agency's four most recent Reports of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks – FFIEC 002.

§ 42.4 Required reports to regulators.

(a) In general. A covered financial institution must submit a report annually to, and in the format directed by, the OCC, that describes the structure of the covered financial institution's incentive-based compensation arrangements for covered persons and that is sufficient to allow an assessment of whether the structure or features of those arrangements provide or are likely to provide covered persons with excessive compensation, fees, or benefits to covered persons or could lead to material financial loss to the covered financial institution.

(b) Individual compensation. A covered financial institution is not required to report the actual compensation of particular covered persons as part of the report required by paragraph (a) of this section.

(c) Minimum standards. The information submitted by the covered financial institution pursuant to paragraph (a) of this section must include the following:

(1) A clear narrative description of the components of the covered financial institution's incentive-based compensation arrangements applicable to covered persons and specifying the types of covered persons to which they apply;

(2) A succinct description of the covered financial institution's policies and procedures governing its incentive-based compensation arrangements for covered persons;

(3) If the covered financial institution has total consolidated assets of $50 billion or more, an additional succinct description of incentive-based compensation policies and procedures specific to the covered financial institution's:

(i) Executive officers; and

(ii) Other covered persons who the board of directors, or a committee thereof, of the covered financial institution has identified and determined under § 42.5(b)(3)(ii) of this part individually have the ability to expose the covered financial institution to possible losses that are substantial in relation to the institution's size, capital, or overall risk tolerance;

(4) Any material changes to the covered financial institution's incentive-based compensation arrangements and policies and procedures made since the covered financial institution's last report submitted under paragraph (a) of this section; and

(5) The specific reasons why the covered financial institution believes the structure of its incentive-based compensation plan does not encourage inappropriate risks by the covered financial institution by providing covered persons with:

(i) Excessive compensation; or

(ii) Incentive-based compensation that could lead to a material financial loss to the covered financial institution.

§ 42.5 Prohibitions.

(a) Excessive compensation prohibition. (1) In general. A covered financial institution must not establish or maintain any type of incentive-based compensation arrangement, or any feature of any such arrangement, that encourages inappropriate risks by the covered financial institution by providing a covered person with excessive compensation.

(2) Standards. An incentive-based compensation arrangement provides excessive compensation when amounts paid are unreasonable or disproportionate to the services performed by a covered person, taking into consideration:

(i) The combined value of all cash and non-cash benefits provided to the covered person;

(ii) The compensation history of the covered person and other individuals with comparable expertise at the covered financial institution;

(iii) The financial condition of the covered financial institution;

(iv) Comparable compensation practices at comparable institutions, based upon such factors as asset size, geographic location, and the complexity of the covered financial institution's operations and assets;

(v) For postemployment benefits, the projected total cost and benefit to the covered financial institution;

(vi) Any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the covered financial institution; and

(vii) Any other factors the OCC determines to be relevant.

(b) Material financial loss prohibition. (1) Generally. A covered financial institution must not establish or maintain any type of incentive-based compensation arrangement, or any feature of any such arrangement, that encourages inappropriate risks by the covered financial institution, by providing incentive-based compensation to covered persons, either individually or as part of a group of persons who are subject to the same or similar incentive-based compensation arrangements, that could lead to material financial loss to the covered financial institution.

(2) Requirements for all covered financial institutions. An incentive-based compensation arrangement established or maintained by a covered financial institution

for one or more covered persons does not comply with paragraph (b)(1) of this section unless it:

(i) Balances risk and financial rewards, for example by using deferral of payments, risk adjustment of awards, reduced sensitivity to short-term performance, or longer performance periods;

(ii) Is compatible with effective controls and risk management; and

(iii) Is supported by strong corporate governance, including active and effective oversight by the covered financial institution's board of directors or a committee thereof.

(3) Specific requirements for covered financial institutions with $50 billion or more in total consolidated assets. (i) Deferral required for executive officers. As part of appropriately balancing risk and financial rewards pursuant to paragraph (b)(2)(i) of this section, any incentive-based compensation arrangement for any executive officer established or maintained by a covered financial institution that has total consolidated assets of $50 billion or more must provide for:

(A) At least 50 percent of the annual incentive-based compensation of the executive officer to be deferred over a period of no less than three years, with the release of deferred amounts to occur no faster than on a pro rata basis; and

(B) The adjustment of the amount required to be deferred under paragraph (b)(3)(i)(A) of this section to reflect actual losses or other measures or aspects of performance that are realized or become better known during the deferral period.

(ii) Additional requirement for covered persons presenting particular loss exposure. As part of appropriately balancing risk and financial rewards pursuant to paragraph (b)(2)(i) of this section, if a covered financial institution has total consolidated assets of $50 billion or more—

(A) The board of directors, or a committee thereof, of the covered financial institution shall identify those covered persons (other than executive officers) who individually have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital, or overall risk tolerance. These covered persons may include, for example, traders with large position limits relative to the institution's overall risk tolerance and other individuals who have the authority to place at risk a substantial part of the capital of the covered financial institution;

(B) The incentive-based compensation arrangement for any covered person identified pursuant to paragraph (b)(3)(ii)(A) of this section must be approved by the board of directors, or a committee thereof, of the covered financial institution and such approval must be documented;

(C) The board of directors, or committee thereof, may not approve the incentive-based compensation arrangement for any covered person identified pursuant to paragraph (b)(3)(ii)(A) of this section unless the board or committee determines that the arrangement, including the method of paying compensation under the arrangement, effectively balances the financial rewards to the covered person and the range and time horizon of risks associated with the covered person's activities, employing appropriate methods for ensuring risk sensitivity such as deferral of payments, risk adjustment of awards, reduced sensitivity to short-term performance, or longer performance periods; and

(D) In fulfilling its duties under paragraph (b)(3)(ii)(C) of this section, the board of directors or committee thereof must evaluate the overall effectiveness of the balancing methods used in the identified covered person's incentive-based compensation arrangements in reducing incentives for inappropriate risk taking by the identified covered person considering the methods' suitability for balancing the full range of risks presented by that covered person's activities, and the methods' ability to make payments sensitive to all the risks arising from the covered person's activities, including those that may be difficult to predict, measure or model.

§ 42.6 Policies and procedures.

(a) In general. Any incentive-based compensation arrangement, or any feature of any such arrangement, is prohibited under § 42.5 of this part, unless adopted pursuant to policies and procedures developed and maintained by each covered financial institution and approved by its board of directors, or a committee thereof, reasonably designed to ensure and monitor compliance with the requirements set forth in 12 U.S.C. 5641 and this part and commensurate with the size and complexity of the organization, as well as the scope and nature of its use of incentive-based compensation.

(b) Standards. The policies and procedures must, at a minimum:

(1) Be consistent with the reporting requirements in § 42.4 of this part and prohibitions in § 42.5 of this part;

(2) Ensure that risk-management, risk-oversight, and internal control personnel have an appropriate role in the covered financial institution's processes for designing incentive-based compensation arrangements and for assessing their effectiveness in restraining inappropriate risk-taking;

(3) Provide for the monitoring by a group or person independent of the covered person, where practicable in light of the covered financial institution's size and complexity, of incentive-based compensation awards and payments, risks taken, and actual risk outcomes to determine whether incentive-based compensation payments for covered persons, or groups of covered persons, are reduced to reflect adverse risk outcomes or high levels of risk taken;

(4) Provide for the covered financial institution's board of directors, or committee thereof, to receive data and analysis from management and other sources sufficient to allow the board, or committee thereof, to assess whether the overall design and performance of the institution's incentive-based compensation arrangements are consistent with 12 U.S.C. 5641;

(5) Ensure that documentation of the covered financial institution's processes for establishing, implementing, modifying, and monitoring incentive-based compensation arrangements is maintained that is sufficient to enable the OCC to determine the institution's compliance with 12 U.S.C. 5641 and this part;

(6) Consistent with § 42.5(b)(3) of this part, where deferral is used in connection with an incentive-based compensation arrangement, provide for deferral of incentive-based compensation awards in amounts and for periods of time appropriate to the duties and responsibilities of the covered financial institution's covered persons, the risks associated with those duties and responsibilities, and the size and complexity of the covered financial institution and provide that the deferral amounts paid are adjusted to reflect actual losses or other measures or aspects of performance that are realized or become better known during the deferral period; and

(7) Subject any incentive-based compensation arrangement to a corporate governance framework that provides for ongoing oversight by the board of directors or a committee thereof, including the approval by the board of directors or a committee thereof of incentive-based compensation to executive officers.

§ 42.7 Evasion.

A covered financial institution is prohibited, for the purpose of evading the restrictions of this part, from doing indirectly or through or by any other person, any act or thing that it would be unlawful for such covered financial institution to do directly under this part.

Federal Reserve Board

12 CFR Chapter II

Authority and Issuance

For the reasons set forth in the joint preamble, the Board proposes to amend 12 CFR Chapter II to read as follows:

2. Add new Part 236 to read as follows:

PART 236 – Incentive-Based Compensation Arrangements (Regulation JJ)

Authority: 12 U.S.C. 24; 321-338a, 1818, 1844(b), 3108 and 5641.

§ 236.1 Authority.

This part is issued pursuant to section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. 5641).

§ 236.2 Scope and purpose.

This part applies to a covered financial institution that has total consolidated assets of $1 billion or more and offers incentive-based compensation arrangements to covered persons. Nothing in this part in any way limits the authority of the Board under other provisions of applicable law and regulations.

§ 236.3 Definitions.

For purposes of this part, the following definitions apply unless otherwise specified:

(a) Board of directors means the governing body of any covered financial institution performing functions similar to a board of directors. For a foreign banking organization, "board of directors" refers to the relevant oversight body for the firm's U.S. branch, agency or operations, consistent with the foreign banking organization's overall corporate and management structure.

(b) Compensation means all direct and indirect payments, fees or benefits, both cash and non-cash, awarded to, granted to, or earned by or for the benefit of, any covered person in exchange for services rendered to the covered financial institution, including, but not limited to, payments or benefits pursuant to an employment contract, compensation or benefit agreement, fee arrangement, perquisite, stock option plan, postemployment benefit, or other compensatory arrangement.

(c) Covered financial institution (1) In general. The term "covered financial institution" means (i) a state member bank, as defined in 12 CFR 208.2(g), that has total consolidated assets of $1 billion or more; (ii) a bank holding company, as defined in 12 CFR 225.2(c), that has total consolidated assets of $1 billion or more; (iii) a state-licensed uninsured branch or agency of a foreign bank, as such terms are defined in section 3 of the Federal Deposit Insurance Act (12 USC 1813), that has total consolidated assets of $1 billion or more; and (iv) the U.S. operations of a foreign bank that is treated as a bank holding company pursuant to section 8(a) of the International Banking Act of 1978 (12 USC 3106(a)) that has total consolidated U.S. assets of $1 billion or more.

(2) Scope of term. A covered financial institution includes the subsidiaries of the institution.

(d) Covered person means any executive officer, employee, director, or principal shareholder of a covered financial institution.

(e) Director of a covered financial institution means a member of the board of directors of the covered financial institution, or of a board or committee performing a similar function to a board of directors.

(f) Executive officer of a covered financial institution means a person who holds the title or, without regard to title, salary, or compensation, performs the function of one or more of the following positions: president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief risk officer, or head of a major business line.

(g) Incentive-based compensation means any variable compensation that serves as an incentive for performance.

(h) Principal shareholder means an individual who directly or indirectly, or acting through or in concert with one or more persons, owns, controls, or has the power to vote 10 percent or more of any class of voting securities of a covered financial institution.

(i) Total consolidated assets means:

(A) For a state member bank, total consolidated assets as determined based on the average of the bank's four most recent Consolidated Reports of Condition and Income ("Call Report");

(B) For a bank holding company, total consolidated assets as determined based on the average of the company's four most recent Consolidated Financial Statements for Bank Holding Companies ("FR Y-9C");

(C) For a state-licensed uninsured branch or agency of a foreign bank, total consolidated assets as determined based on the average of the branch or agency's four most recent Call Reports; and

(D) For the U.S. operations of a foreign bank total consolidated U.S. assets as determined by the Board.

§ 236.4 Required reports to regulators.

(a) In general. A covered financial institution must submit a report annually to, and in the format directed by, the Board, that describes the structure of the covered financial institution's incentive-based compensation arrangements for covered persons and that is sufficient to allow an assessment of whether the structure or features of those arrangements provide or are likely to provide covered persons with excessive compensation, fees, or benefits to covered persons or could lead to material financial loss to the covered financial institution.

(b) Individual compensation. A covered financial institution is not required to report the actual compensation of particular covered persons as part of the report required by paragraph (a) of this section.

(c) Minimum standards. The information submitted by the covered financial institution pursuant to paragraph (a) of this section must include the following:

(1) A clear narrative description of the components of the covered financial institution's incentive-based compensation arrangements applicable to covered persons and specifying the types of covered persons to which they apply;

(2) A succinct description of the covered financial institution's policies and procedures governing its incentive-based compensation arrangements for covered persons;

(3) If the covered financial institution has total consolidated assets of $50 billion or more, an additional succinct description of incentive-based compensation policies and procedures specific to the covered financial institution's:

(i) Executive officers; and

(ii) Other covered persons who the board of directors, or a committee thereof, of the covered financial institution has identified and determined under § 236.5(b)(3)(ii) of this part individually have the ability to expose the covered financial institution to possible losses that are substantial in relation to the institution's size, capital, or overall risk tolerance;

(4) Any material changes to the covered financial institution's incentive-based compensation arrangements and policies and procedures made since the covered financial institution's last report submitted under paragraph (a) of this section; and

(5) The specific reasons why the covered financial institution believes the structure of its incentive-based compensation plan does not encourage inappropriate risks by the covered financial institution by providing covered persons with:

(i) Excessive compensation; or

(ii) Incentive-based compensation that could lead to a material financial loss to the covered financial institution.

§ 236.5 Prohibitions.

(a) Excessive compensation prohibition. (1) In general. A covered financial institution must not establish or maintain any type of incentive-based compensation arrangement, or any feature of any such arrangement, that encourages inappropriate risks by the covered financial institution by providing a covered person with excessive compensation.

(2) Standards. An incentive-based compensation arrangement provides excessive compensation when amounts paid are unreasonable or disproportionate to the services performed by a covered person, taking into consideration:

(i) The combined value of all cash and non-cash benefits provided to the covered person;

(ii) The compensation history of the covered person and other individuals with comparable expertise at the covered financial institution;

(iii) The financial condition of the covered financial institution;

(iv) Comparable compensation practices at comparable institutions, based upon such factors as asset size, geographic location, and the complexity of the covered financial institution's operations and assets;

(v) For postemployment benefits, the projected total cost and benefit to the covered financial institution;

(vi) Any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the covered financial institution; and

(vii) Any other factors the Board determines to be relevant.

(b) Material financial loss prohibition. (1) Generally. A covered financial institution must not establish or maintain any type of incentive-based compensation arrangement, or any feature of any such arrangement, that encourages inappropriate risks by the covered financial institution, by providing incentive-based compensation to covered persons, either individually or as part of a group of persons who are subject to the same or similar incentive-based compensation arrangements, that could lead to material financial loss to the covered financial institution.

(2) Requirements for all covered financial institutions. An incentive-based compensation arrangement established or maintained by a covered financial institution for one or more covered persons does not comply with paragraph (b)(1) of this section unless it:

(i) Balances risk and financial rewards, for example by using deferral of payments, risk adjustment of awards, reduced sensitivity to short-term performance, or longer performance periods;

(ii) Is compatible with effective controls and risk management; and

(iii) Is supported by strong corporate governance, including active and effective oversight by the covered financial institution's board of directors or a committee thereof.

(3) Specific requirements for covered financial institutions with $50 billion or more in total consolidated assets. (i) Deferral required for executive officers. As part of appropriately balancing risk and financial rewards pursuant to paragraph (b)(2)(i) of this

section, any incentive-based compensation arrangement for any executive officer established or maintained by a covered financial institution that has total consolidated assets of $50 billion or more must provide for:

(A) At least 50 percent of the annual incentive-based compensation of the executive officer to be deferred over a period of no less than three years, with the release of deferred amounts to occur no faster than on a pro rata basis; and

(B) The adjustment of the amount required to be deferred under paragraph (b)(3)(i)(A) of this section to reflect actual losses or other measures or aspects of performance that are realized or become better known during the deferral period.

(ii) Additional requirement for covered persons presenting particular loss exposure. As part of appropriately balancing risk and financial rewards pursuant to paragraph (b)(2)(i) of this section, if a covered financial institution has total consolidated assets of $50 billion or more—

(A) The board of directors, or a committee thereof, of the covered financial institution shall identify those covered persons (other than executive officers) who individually have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital, or overall risk tolerance. These covered persons may include, for example, traders with large position limits relative to the institution's overall risk tolerance and other individuals who have the authority to place at risk a substantial part of the capital of the covered financial institution;

(B) The incentive-based compensation arrangement for any covered person identified pursuant to paragraph (b)(3)(ii)(A) of this section must be approved by the board of directors, or a committee thereof, of the covered financial institution and such approval must be documented;

(C) The board of directors, or committee thereof, may not approve the incentive-based compensation arrangement for any covered person identified pursuant to paragraph (b)(3)(ii)(A) of this section unless the board or committee determines that the arrangement, including the method of paying compensation under the arrangement, effectively balances the financial rewards to the covered person and the range and time horizon of risks associated with the covered person's activities, employing appropriate methods for ensuring risk sensitivity such as deferral of payments, risk adjustment of awards, reduced sensitivity to short-term performance, or longer performance periods; and

(D) In fulfilling its duties under paragraph (b)(3)(ii)(C) of this section, the board of directors or committee thereof must evaluate the overall effectiveness of the balancing methods used in the identified covered person's incentive-based compensation arrangements in reducing incentives for inappropriate risk taking by the identified covered person considering the methods' suitability for balancing the full range of risks presented by that covered person's activities, and the methods' ability to make payments sensitive to all the risks arising from the covered person's activities, including those that may be difficult to predict, measure or model.

§ 236.6 Policies and procedures.

(a) In general. Any incentive-based compensation arrangement, or any feature of any such arrangement, is prohibited under § 236.5 of this part, unless adopted pursuant to policies and procedures developed and maintained by each covered financial institution and approved by its board of directors, or a committee thereof, reasonably designed to ensure and monitor compliance with the requirements set forth in 12 U.S.C. 5641 and this part and commensurate with the size and complexity of the organization, as well as the scope and nature of its use of incentive-based compensation.

(b) Standards. The policies and procedures must, at a minimum:

(1) Be consistent with the reporting requirements in § 236.4 of this part and prohibitions in § 236.5 of this part;

(2) Ensure that risk-management, risk-oversight, and internal control personnel have an appropriate role in the covered financial institution's processes for designing incentive-based compensation arrangements and for assessing their effectiveness in restraining inappropriate risk-taking;

(3) Provide for the monitoring by a group or person independent of the covered person, where practicable in light of the covered financial institution's size and complexity, of incentive-based compensation awards and payments, risks taken, and actual risk outcomes to determine whether incentive compensation payments for covered persons, or groups of covered persons, are reduced to reflect adverse risk outcomes or high levels of risk taken;

(4) Provide for the covered financial institution's board of directors, or committee thereof, to receive data and analysis from management and other sources sufficient to allow the board, or committee thereof, to assess whether the overall design and performance of the institution's incentive-based compensation arrangements are consistent with 12 U.S.C. 5641;

(5) Ensure that documentation of the covered financial institution's processes for establishing, implementing, modifying, and monitoring incentive-based compensation

arrangements is maintained that is sufficient to enable the Board to determine the institution's compliance with 12 U.S.C. 5641 and this part;

(6) Consistent with § 236.5(b)(3) of this part, where deferral is used in connection with an incentive-based compensation arrangement, provide for deferral of incentive-based compensation awards in amounts and for periods of time appropriate to the duties and responsibilities of the covered financial institution's covered persons, the risks associated with those duties and responsibilities, and the size and complexity of the covered financial institution and provide that the deferral amounts paid are adjusted to reflect actual losses or other measures or aspects of performance that are realized or become better known during the deferral period; and

(7) Subject any incentive-based compensation arrangement to a corporate governance framework that provides for ongoing oversight by the board of directors or a committee thereof, including the approval by the board of directors or a committee thereof of incentive-based compensation to executive officers.

§ 236.7 Evasion.

A covered financial institution is prohibited, for the purpose of evading the restrictions of this part, from doing indirectly or through or by any other person, any act or thing that it would be unlawful for such covered financial institution to do directly under this part.

Federal Deposit Insurance Corporation

12 CFR Chapter III

Authority and Issuance

For the reasons set forth in the preamble, the Federal Deposit Insurance

Corporation proposes to amend chapter III of title 12 of the Code of Federal Regulations to add a new part 372 as follows:

3. Add new part 372 to read as follows

PART 372 – INCENTIVE-BASED COMPENSATION ARRANGEMENTS

Incentive-Based Compensation Arrangements

Authority: 12 U.S.C. 1819 Tenth, 12 U.S.C. 5641.

§372.1 Authority.

This part is issued pursuant to section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. 5641).

§372.2 Scope and purpose.

This part applies to a covered financial institution that has total consolidated assets of $1 billion or more and offers incentive-based compensation arrangements to covered persons. Nothing in this part in any way limits the authority of the Corporation under other provisions of applicable law and regulations.

§372.3 Definitions.

For purposes of this part, the following definitions apply unless otherwise specified:

(a) Board of directors means the governing body of any covered financial institution performing functions similar to a board of directors. For an insured U.S. branch of a foreign bank, "board of directors" means the senior management of its parent foreign bank.

(b) Compensation means all direct and indirect payments, fees or benefits, both cash and non-cash, awarded to, granted to, or earned by or for the benefit of, any covered person in exchange for services rendered to the covered financial institution, including, but not limited to, payments or benefits pursuant to an employment contract, compensation or benefit agreement, fee arrangement, perquisite, stock option plan, postemployment benefit, or other compensatory arrangement.

(c) Covered financial institution means a state nonmember bank and an insured U.S. branch of a foreign bank that has total consolidated assets of $1 billion or more.

(d) Covered person means any executive officer, employee, director, or principal shareholder of a covered financial institution.

(e) Director of a covered financial institution means a member of the board of directors of the covered financial institution, or of a board or committee performing a similar function to a board of directors.

(f) Executive officer of a covered financial institution means a person who holds the title or, without regard to title, salary, or compensation, performs the function of one or more of the following positions: president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief risk officer, or head of a major business line.

(g) Incentive-based compensation means any variable compensation that serves as an incentive for performance.

(h) Principal shareholder means an individual who directly or indirectly, or acting through or in concert with one or more persons, owns, controls, or has the power to vote 10 percent or more of any class of voting securities of a covered financial institution.

(i) Total consolidated assets means:

(A) For a state nonmember bank, the average of the total assets reported in the bank's four most recent Consolidated Reports of Condition and Income; and

(B) For an insured U.S. branch of a foreign bank, the average of the total assets reported in the branch's four most recent Reports of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks.

§372.4 Required reports to regulators.

(a) In general. A covered financial institution must submit a report annually to, and in the format directed by, the Corporation, that describes the structure of the covered financial institution's incentive-based compensation arrangements for covered persons and that is sufficient to allow an assessment of whether the structure or features of those arrangements provide or are likely to provide covered persons with excessive compensation, fees, or benefits to covered persons or could lead to material financial loss to the covered financial institution.

(b) Individual compensation. A covered financial institution is not required to report the actual compensation of particular covered persons as part of the report required by paragraph (a) of this section.

(c) Minimum standards. The information submitted by the covered financial institution pursuant to paragraph (a) of this section must include the following:

(1) A clear narrative description of the components of the covered financial institution's incentive-based compensation arrangements applicable to covered persons and specifying the types of covered persons to which they apply;

(2) A succinct description of the covered financial institution's policies and procedures governing its incentive-based compensation arrangements for covered persons;

(3) If the covered financial institution has total consolidated assets of $50 billion or more, an additional succinct description of incentive-based compensation policies and procedures specific to the covered financial institution's:

(i) Executive officers; and

(ii) Other covered persons who the board of directors, or a committee thereof, of the covered financial institution has identified and determined under §372.5(b)(3)(ii) of this part individually have the ability to expose the covered financial institution to possible losses that are substantial in relation to the institution's size, capital, or overall risk tolerance;

(4) Any material changes to the covered financial institution's incentive-based compensation arrangements and policies and procedures made since the covered financial institution's last report submitted under paragraph (a) of this section; and

(5) The specific reasons why the covered financial institution believes the structure of its incentive-based compensation plan does not encourage inappropriate risks by the covered financial institution by providing covered persons with:

(i) Excessive compensation; or

(ii) Incentive-based compensation that could lead to a material financial loss to the covered financial institution.

§372.5 Prohibitions.

(a) Excessive compensation prohibition. (1) In general. A covered financial institution must not establish or maintain any type of incentive-based compensation arrangement, or any feature of any such arrangement, that encourages inappropriate risks by the covered financial institution by providing a covered person with excessive compensation.

(2) Standards. An incentive-based compensation arrangement provides excessive compensation when amounts paid are unreasonable or disproportionate to the services performed by a covered person, taking into consideration:

(i) The combined value of all cash and non-cash benefits provided to the covered person;

(ii) The compensation history of the covered person and other individuals with comparable expertise at the covered financial institution;

(iii) The financial condition of the covered financial institution;

(iv) Comparable compensation practices at comparable institutions, based upon such factors as asset size, geographic location, and the complexity of the covered financial institution's operations and assets;

(v) For postemployment benefits, the projected total cost and benefit to the covered financial institution;

(vi) Any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the covered financial institution; and

(vii) Any other factors the Corporation determines to be relevant.

(b) Material financial loss prohibition.

(1) Generally. A covered financial institution must not establish or maintain any type of incentive-based compensation arrangement, or any feature of any such arrangement, that encourages inappropriate risks by the covered financial institution, by providing incentive-based compensation to covered persons, either individually or as part of a group of persons who are subject to the same or similar incentive-based compensation arrangements, that could lead to material financial loss to the covered financial institution.

(2) Requirements for all covered financial institutions. An incentive-based compensation arrangement established or maintained by a covered financial institution for one or more covered persons does not comply with paragraph (b)(1) of this section unless it:

(i) Balances risk and financial rewards, for example by using deferral of payments, risk adjustment of awards, reduced sensitivity to short-term performance, or longer performance periods;

(ii) Is compatible with effective controls and risk management; and

(iii) Is supported by strong corporate governance, including active and effective oversight by the covered financial institution's board of directors or a committee thereof.

(3) Specific requirements for covered financial institutions with $50 billion or more in total consolidated assets.

(i) Deferral required for executive officers. As part of appropriately balancing risk and financial rewards pursuant to paragraph (b)(2)(i) of this section, any incentive-based compensation arrangement for any executive officer established or maintained by a covered financial institution that has total consolidated assets of $50 billion or more must provide for:

(A) At least 50 percent of the annual incentive-based compensation of the executive officer to be deferred over a period of no less than three years, with the release of deferred amounts to occur no faster than on a pro rata basis; and

(B) The adjustment of the amount required to be deferred under paragraph (b)(3)(i)(A) of this section to reflect actual losses or other measures or aspects of performance that are realized or become better known during the deferral period.

(ii) Additional requirement for covered persons presenting particular loss exposure. As part of appropriately balancing risk and financial rewards pursuant to paragraph (b)(2)(i) of this section, if a covered financial institution has total consolidated assets of $50 billion or more—

(A) The board of directors, or a committee thereof, of the covered financial institution shall identify those covered persons (other than executive officers) who individually have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital, or overall risk tolerance. These covered persons may include, for example, traders with large position limits relative to the institution's overall risk tolerance and other individuals who have the authority to place at risk a substantial part of the capital of the covered financial institution;

(B) The incentive-based compensation arrangement for any covered person identified pursuant to paragraph (b)(3)(ii)(A) of this section must be approved by the board of directors, or a committee thereof, of the covered financial institution and such approval must be documented;

(C) The board of directors, or committee thereof, may not approve the incentive-based compensation arrangement for any covered person identified pursuant to paragraph (b)(3)(ii)(A) of this section unless the board or committee determines that the arrangement, including the method of paying compensation under the arrangement, effectively balances the financial rewards to the covered person and the range and time horizon of risks associated with the covered person's activities, employing appropriate methods for ensuring risk sensitivity such as deferral of payments, risk adjustment of awards, reduced sensitivity to short-term performance, or longer performance periods; and

(D) In fulfilling its duties under paragraph (b)(3)(ii)(C) of this section, the board of directors or committee thereof must evaluate the overall effectiveness of the balancing methods used in the identified covered person's incentive compensation arrangements in reducing incentives for inappropriate risk taking by the identified covered person considering the methods' suitability for balancing the full range of risks presented by that covered person's activities, and the methods' ability to make payments sensitive to all the risks arising from the covered person's activities, including those that may be difficult to predict, measure or model.

§372.6 Policies and procedures.

(a) In general. Any incentive-based compensation arrangement, or any feature of any such arrangement, is prohibited under § 372.5 of this part, unless adopted pursuant to policies and procedures developed and maintained by each covered financial institution and approved by its board of directors, or a committee thereof, reasonably designed to ensure and monitor compliance with the requirements set forth in 12 U.S.C. 5641 and this part and commensurate with the size and complexity of the organization, as well as the scope and nature of its use of incentive-based compensation.

(b) Standards. The policies and procedures must, at a minimum:

(1) Be consistent with the reporting requirements in § 372.4 of this part and prohibitions in § 372.5 of this part;

(2) Ensure that risk-management, risk-oversight, and internal control personnel have an appropriate role in the covered financial institution's processes for designing incentive-based compensation arrangements and for assessing their effectiveness in restraining inappropriate risk-taking;

(3) Provide for the monitoring by a group or person independent of the covered person, where practicable in light of the covered financial institution's size and complexity, of incentive-based compensation awards and payments, risks taken, and actual risk

outcomes to determine whether incentive compensation payments for covered persons, or groups of covered persons, are reduced to reflect adverse risk outcomes or high levels of risk taken;

(4) Provide for the covered financial institution's board of directors, or committee thereof, to receive data and analysis from management and other sources sufficient to allow the board, or committee thereof, to assess whether the overall design and performance of the covered financial institution's incentive-based compensation arrangements are consistent with 12 U.S.C. 5641;

(5) Ensure that documentation of the covered financial institution's processes for establishing, implementing, modifying, and monitoring incentive-based compensation arrangements is maintained that is sufficient to enable the Corporation to determine the institution's compliance with 12 U.S.C. 5641 and this part;

(6) Consistent with § 372.5(b)(3) of this part, where deferral is used in connection with an incentive-based compensation arrangement, provide for deferral of incentive-based compensation awards in amounts and for periods of time appropriate to the duties and responsibilities of the covered financial institution's covered persons, the risks associated with those duties and responsibilities, and the size and complexity of the covered financial institution and provide that the deferral amounts paid are adjusted to reflect actual losses or other measures or aspects of performance that are realized or become better known during the deferral period; and

(7) Subject any incentive-based compensation arrangement to a corporate governance framework that provides for ongoing oversight by the board of directors or a

committee thereof, including the approval by the board of directors or a committee thereof of incentive-based compensation to executive officers.

§372.7 Evasion.

A covered financial institution is prohibited, for the purpose of evading the restrictions of this part, from doing indirectly or through or by any other person, any act or thing that it would be unlawful for such covered financial institution to do directly under this part.

Department of the Treasury
Office of Thrift Supervision

12 CFR Chapter V

For the reasons set forth in the joint preamble, the Office of Thrift Supervision proposes to amend chapter V of title 12 of the Code of Federal Regulations to read as follows:

4. Add part 563h to read as follows:

PART 563h – Incentive-Based Compensation Arrangements

Sec.

Authority: 12 U.S.C. 1462a, 1463, 1464, 1467a, and 5641.

§ 563h.1 Authority.

This part is issued pursuant to section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. 5641).

§ 563h.2 Scope and purpose.

This part applies to a covered financial institution that has total consolidated assets of $1 billion or more and offers incentive-based compensation arrangements to covered persons. Nothing in this part in any way limits the authority of the OTS under other provisions of applicable law and regulations.

§ 563h.3 Definitions.

For purposes of this part, the following definitions apply unless otherwise specified:

(a) Board of directors means the governing body of any covered financial institution performing functions similar to a board of directors.

(b) Compensation means all direct and indirect payments, fees or benefits, both cash and non-cash, awarded to, granted to, or earned by or for the benefit of, any covered person in exchange for services rendered to the covered financial institution, including, but not limited to, payments or benefits pursuant to an employment contract, compensation or benefit agreement, fee arrangement, perquisite, stock option plan, postemployment benefit, or other compensatory arrangement.

(c) Covered financial institution means a savings association as defined in 12 U.S.C. 1813(b) and a savings and loan holding company as defined in 12 U.S.C. 1467a(a), that has total consolidated assets of $1 billion or more.

(d) Covered person means any executive officer, employee, director, or principal shareholder of a covered financial institution.

(e) Director of a covered financial institution means a member of the board of directors of the covered financial institution, or of a board or committee performing a similar function to a board of directors.

(f) Executive officer of a covered financial institution means a person who holds the title or, without regard to title, salary, or compensation, performs the function of one or more of the following positions: president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief risk officer, or head of a major business line.

(g) Incentive-based compensation means any variable compensation that serves as an incentive for performance.

(h) Principal shareholder means an individual who directly or indirectly, or acting through or in concert with one or more persons, owns, controls, or has the power to vote 10 percent or more of any class of voting securities of a covered financial institution.

(i) Total consolidated assets means total consolidated assets determined based on the average of the covered financial institution's four most recent Thrift Financial Reports.

§563h.4 Required reports to regulators.

(a) In general. A covered financial institution must submit a report annually to, and in the format directed by, the OTS, that describes the structure of the covered financial institution's incentive-based compensation arrangements for covered persons and that is sufficient to allow an assessment of whether the structure or features of those arrangements provide or are likely to provide covered persons with excessive compensation, fees, or benefits to covered persons or could lead to material financial loss to the covered financial institution.

(b) Individual compensation. A covered financial institution is not required to report the actual compensation of particular covered persons as part of the report required by paragraph (a) of this section.

(c) Minimum standards. The information submitted by the covered financial institution pursuant to paragraph (a) of this section must include the following:

(1) A clear narrative description of the components of the covered financial institution's incentive-based compensation arrangements applicable to covered persons and specifying the types of covered persons to which they apply;

(2) A succinct description of the covered financial institution's policies and procedures governing its incentive-based compensation arrangements for covered persons;

(3) If the covered financial institution has total consolidated assets of $50 billion or more, an additional succinct description of incentive-based compensation policies and procedures specific to the covered financial institution's:

(i) Executive officers; and

(ii) Other covered persons who the board of directors, or a committee thereof, of the covered financial institution has identified and determined under §563h.5(b)(3)(ii) of this part individually have the ability to expose the covered financial institution to possible losses that are substantial in relation to the institution's size, capital, or overall risk tolerance;

(4) Any material changes to the covered financial institution's incentive-based compensation arrangements and policies and procedures made since the covered financial institution's last report submitted under paragraph (a) of this section; and

(5) The specific reasons why the covered financial institution believes the structure of its incentive-based compensation plan does not encourage inappropriate risks by the covered financial institution by providing covered persons with:

(i) Excessive compensation; or

(ii) Incentive-based compensation that could lead to material financial loss to the covered financial institution.

§563h.5 Prohibitions.

(a) Excessive compensation prohibition. (1) In general. A covered financial institution must not establish or maintain any type of incentive-based compensation arrangement, or any feature of any such arrangement, that encourages inappropriate risks by the covered financial institution by providing a covered person with excessive compensation.

(2) Standards. An incentive-based compensation arrangement provides excessive compensation when amounts paid are unreasonable or disproportionate to the services performed by a covered person, taking into consideration:

(i) The combined value of all cash and non-cash benefits provided to the covered person;

(ii) The compensation history of the covered person and other individuals with comparable expertise at the covered financial institution;

(iii) The financial condition of the covered financial institution;

(iv) Comparable compensation practices at comparable institutions, based upon such factors as asset size, geographic location, and the complexity of the covered financial institution's operations and assets;

(v) For postemployment benefits, the projected total cost and benefit to the covered financial institution;

(vi) Any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the covered financial institution; and

(vii) Any other factors the OTS determines to be relevant.

(b) Material financial loss prohibition. (1) Generally. A covered financial institution must not establish or maintain any type of incentive-based compensation arrangement, or any feature of any such arrangement, that encourages inappropriate risks by the covered financial institution, by providing incentive-based compensation to covered persons, either individually or as part of a group of persons who are subject to the same or similar incentive-based compensation arrangements, that could lead to material financial loss to the covered financial institution.

(2) Requirements for all covered financial institutions. An incentive-based compensation arrangement established or maintained by a covered financial institution for one or more covered persons does not comply with paragraph (b)(1) of this section unless it:

(i) Balances risk and financial rewards, for example by using deferral of payments, risk adjustment of awards, reduced sensitivity to short-term performance, or longer performance periods;

(ii) Is compatible with effective controls and risk management; and

(iii) Is supported by strong corporate governance, including active and effective oversight by the covered financial institution's board of directors or a committee thereof.

(3) Specific requirements for covered financial institutions with $50 billion or more in total consolidated assets. (i) Deferral required for executive officers. As part of appropriately balancing risk and financial rewards pursuant to paragraph (b)(2)(i) of this section, any incentive-based compensation arrangement for any executive officer established or maintained by a covered financial institution that has total consolidated assets of $50 billion or more must provide for:

(A) At least 50 percent of the annual incentive-based compensation of the executive officer to be deferred over a period of no less than three years, with the release of deferred amounts to occur no faster than on a pro rata basis; and

(B) The adjustment of the amount required to be deferred under paragraph (b)(3)(i)(A) of this section to reflect actual losses or other measures or aspects of performance that are realized or become better known during the deferral period.

(ii) Additional requirement for covered persons presenting particular loss exposure. As part of appropriately balancing risk and financial rewards pursuant to paragraph (b)(2)(i) of this section, if a covered financial institution has total consolidated assets of $50 billion or more—

(A) The board of directors, or a committee thereof, of the covered financial institution shall identify those covered persons (other than executive officers) who individually have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital, or overall risk tolerance. These covered persons may include, for example, traders with large position limits relative to the institution's overall risk tolerance and other individuals who have the authority to place at risk a substantial part of the capital of the covered financial institution;

(B) The incentive-based compensation arrangement for any covered person identified pursuant to paragraph (b)(3)(ii)(A) of this section must be approved by the board of directors, or a committee thereof, of the covered financial institution and such approval must be documented;

(C) The board of directors, or committee thereof, may not approve the incentive-based compensation arrangement for any covered person identified pursuant to paragraph (b)(3)(ii)(A) of this section unless the board or committee determines that the arrangement, including the method of paying compensation under the arrangement, effectively balances the financial rewards to the covered person and the range and time horizon of risks associated with the covered person's activities, employing appropriate methods for ensuring risk sensitivity such as deferral of payments, risk adjustment of awards, reduced sensitivity to short-term performance, or longer performance periods; and

(D) In fulfilling its duties under paragraph (b)(3)(ii)(C) of this section, the board of directors, or committee thereof, must evaluate the overall effectiveness of the balancing methods used in the identified covered person's incentive-based compensation arrangements in reducing incentives for inappropriate risk taking by the identified covered person considering the methods' suitability for balancing the full range of risks presented by that covered person's activities, and the methods' ability to make payments sensitive to all the risks arising from the covered person's activities, including those that may be difficult to predict, measure, or model.

§ 563h.6 Policies and procedures.

(a) In general. Any incentive-based compensation arrangement, or any feature of any such arrangement, is prohibited under § 563h.5 of this part, unless adopted pursuant to policies and procedures developed and maintained by each covered financial institution and approved by its board of directors, or a committee thereof, reasonably designed to ensure and monitor compliance with the requirements set forth in 12 U.S.C. 5641 and this part and commensurate with the size and complexity of the organization, as well as the scope and nature of its use of incentive-based compensation.

(b) Standards. The policies and procedures must, at a minimum:

(1) Be consistent with the reporting requirements in § 563h.4 of this part and prohibitions in § 563h.5 of this part;

(2) Ensure that risk-management, risk-oversight, and internal control personnel have an appropriate role in the covered financial institution's processes for designing incentive-based compensation arrangements and for assessing their effectiveness in restraining inappropriate risk-taking;

(3) Provide for the monitoring by a group or person independent of the covered person, where practicable in light of the covered financial institution's size and complexity, of incentive-based compensation awards and payments, risks taken, and actual risk outcomes to determine whether incentive compensation payments for covered persons, or groups of covered persons, are reduced to reflect adverse risk outcomes or high levels of risk taken;

(4) Provide for the covered financial institution's board of directors, or committee thereof, to receive data and analysis from management and other sources sufficient to

allow the board, or committee thereof, to assess whether the overall design and performance of the institution's incentive-based compensation arrangements are consistent with 12 U.S.C. 5641;

(5) Ensure that documentation of the covered financial institution's processes for establishing, implementing, modifying, and monitoring incentive-based compensation arrangements is maintained that is sufficient to enable the OTS to determine the institution's compliance with 12 U.S.C. 5641 and this part;

(6) Consistent with § 563h.5(b)(3) of this part, where deferral is used in connection with an incentive-based compensation arrangement, provide for deferral of incentive-based compensation awards in amounts and for periods of time appropriate to the duties and responsibilities of the covered financial institution's covered persons, the risks associated with those duties and responsibilities, and the size and complexity of the covered financial institution and provide that the deferral amounts paid are adjusted to reflect actual losses or other measures or aspects of performance that are realized or become better known during the deferral period; and

(7) Subject any incentive-based compensation arrangement to a corporate governance framework that provides for ongoing oversight by the board of directors or a committee thereof, including the approval by the board of directors or a committee thereof of incentive-based compensation to executive officers.

§ 563h.7 Evasion.

A covered financial institution is prohibited, for the purpose of evading the restrictions of this part, from doing indirectly or through or by any other person, any act or thing that it would be unlawful for such covered financial institution to do directly under this part.

National Credit Union Administration

12 CFR Chapter VII

Authority and Issuance

For the reasons stated in the preamble, the National Credit Union Administration proposes to amend chapter VII of title 12 of the Code of Federal Regulations as follows:

PART 741 – REQUIREMENTS FOR INSURANCE

5. The authority citation for part 741 continues to read as follows:

Authority: 12 U.S.C. 1757, 1766, 1781-1790, and 1790d.

6. Add a new §741.225 to subpart B to read as follows:

§741.225 Incentive-Based Compensation Arrangements.

Any credit union which is insured pursuant to Title II of the Act must adhere to the requirements stated in part 751 of this chapter.

7. Add a new part 751 to subchapter A to read as follows:

Part 751 Incentive-Based Compensation Arrangements

Sec.

751.1	Authority.
751.2	Scope and purpose.
751.3	Definitions.
751.4	Required reports to regulators.
751.5	Prohibitions.
751.6	Policies and procedures.
751.7	Evasion.

Authority: 12 U.S.C. 1751 et seq. and 5641.

§751.1 Authority.

This part is issued pursuant to section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. 5641).

§751.2 Scope and purpose.

This part applies to any federally insured credit union, or credit union eligible to make application to become an insured credit union under 12 U.S.C. 1781, with total consolidated assets of $1 billion or more, and offers incentive-based compensation arrangements to covered persons. Nothing in this part in any way limits the authority of the NCUA under other provisions of applicable law and regulations.

§751.3 Definitions.

For purposes of this part, the following definitions apply unless otherwise specified:

(a) Board of directors means the governing body of any credit union.

(b) Compensation means all direct and indirect payments, fees or benefits, both cash and non-cash, awarded to, granted to, or earned by or for the benefit of, any covered person in exchange for services rendered to the credit union, including, but not limited to, payments or benefits pursuant to an employment contract, compensation or benefit agreement, fee arrangement, perquisite, post-employment benefit, or other compensatory arrangement. Consistent with § 701.33 of this chapter, the term compensation specifically excludes reimbursement for reasonable and proper costs incurred by covered persons in carrying out official credit union business; provision of reasonable health, accident and related types of personal insurance protection; and indemnification.

(c) [Reserved]

(d) Covered person means any executive officer, employee, or director of a credit union.

(e) [Reserved]

(f) Executive officer of a credit union means a person who holds the title or, without regard to title, salary, or compensation, performs the function of one or more of the following positions: president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief risk officer, or head of a major business line.

(g) Incentive-based compensation means any variable compensation that serves as an incentive for performance.

(h) [Reserved]

(i) Total consolidated assets means calculating the average of the total assets reported in the credit union's four most recent 5300 Call Reports.

§751.4 Required reports to regulators.

(a) In general. A credit union must submit a report annually to, and in the format directed by, the NCUA, that describes the structure of the credit union's incentive-based compensation arrangements for covered persons and that is sufficient to allow an assessment of whether the structure or features of those arrangements provide or are likely to provide covered persons with excessive compensation, fees, or benefits to covered persons or could lead to material financial loss to the credit union.

(b) Individual compensation. A credit union is not required to report the actual compensation of particular covered persons as part of the report required by paragraph (a) of this section.

(c) Minimum standards. The information submitted by the credit union pursuant to paragraph (a) of this section must include the following:

(1) A clear narrative description of the components of the credit union's incentive-based compensation arrangements applicable to covered persons and specifying the types of covered persons to which they apply;

(2) A succinct description of the credit union's policies and procedures governing its incentive-based compensation arrangements for covered persons;

(3) If the credit union has total consolidated assets of $10 billion or more, an additional succinct description of incentive-based compensation policies and procedures specific to the credit union's:

(i) Executive officers; and

(ii) Other covered persons who the board of directors, or a committee thereof, of the credit union has identified and determined under §751.5(b)(3)(ii) of this part individually have the ability to expose the credit union to possible losses that are substantial in relation to the credit union's size, capital, or overall risk tolerance;

(4) Any material changes to the credit union's incentive-based compensation arrangements and policies and procedures made since the credit union's last report submitted under paragraph (a) of this section; and

(5) The specific reasons why the credit union believes the structure of its incentive-based compensation plan does not encourage inappropriate risks by the credit union by providing covered persons with:

(i) Excessive compensation; or

(ii) Incentive-based compensation that could lead to material financial loss to the credit union.

§751.5 Prohibitions.

(a) Excessive compensation prohibition. (1) In general. A credit union must not establish or maintain any type of incentive-based compensation arrangement, or any feature of any such arrangement, that encourages inappropriate risks by the credit union by providing a covered person with excessive compensation.

(2) Standards. An incentive-based compensation arrangement provides excessive compensation when amounts paid are unreasonable or disproportionate to the services performed by a covered person, taking into consideration:

(i) The combined value of all cash and non-cash benefits provided to the covered person;

(ii) The compensation history of the covered person and other individuals with comparable expertise at the credit union;

(iii) The financial condition of the credit union;

(iv) Comparable compensation practices at comparable institutions, based upon such factors as asset size, geographic location, and the complexity of the credit union's operations and assets;

(v) For postemployment benefits, the projected total cost and benefit to the credit union;

(vi) Any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the credit union; and

(vii) Any other factors the NCUA determines to be relevant.

(b) Material financial loss prohibition. (1) Generally. A credit union must not establish or maintain any type of incentive-based compensation arrangement, or any feature of any such arrangement, that encourages inappropriate risks by the credit union, by providing incentive-based compensation to covered persons, either individually or as part of a group of persons who are subject to the same or similar incentive-based compensation arrangements, that could lead to material financial loss to the credit union.

(2) Requirements for all credit unions. An incentive-based compensation arrangement established or maintained by a credit union for one or more covered persons does not comply with paragraph (b)(1) of this section unless it:

(i) Balances risk and financial rewards, for example by using deferral of payments, risk adjustment of awards, reduced sensitivity to short-term performance, or longer performance periods;

(ii) Is compatible with effective controls and risk management; and

(iii) Is supported by strong corporate governance, including active and effective oversight by the credit union's board of directors or a committee thereof.

(3) Specific requirements for credit unions with $10 billion or more in total consolidated assets.

(i) Deferral required for executive officers. As part of appropriately balancing risk and financial rewards pursuant to paragraph (b)(2)(i) of this section, any incentive-based compensation arrangement for any executive officer, established or maintained by a credit union that has total consolidated assets of $10 billion or more, must provide for:

(A) At least 50 percent of the annual incentive-based compensation of the executive officer to be deferred over a period of no less than three years, with the release of deferred amounts to occur no faster than on a pro rata basis; and

(B) The adjustment of the amount required to be deferred under paragraph (b)(3)(i)(A) of this section to reflect actual losses or other measures or aspects of performance that are realized or become better known during the deferral period.

(ii) Additional requirement for covered persons presenting particular loss exposure. As part of appropriately balancing risk and financial rewards pursuant to paragraph (b)(2)(i) of this section, if a credit union has total consolidated assets of $10 billion or more -

(A) The board of directors, or a committee thereof, of the credit union shall identify those covered persons (other than executive officers) who individually have the ability to expose the credit union to possible losses that are substantial in relation to the credit union's size, capital, or overall risk tolerance. These covered persons may include, for example, individuals who have the authority to place at risk a substantial part of the credit union's capital;

(B) The incentive-based compensation arrangement for any covered person identified pursuant to paragraph (b)(3)(ii)(A) of this section must be approved by the board of directors, or a committee thereof, of the credit union and such approval must be documented;

(C) The board of directors, or committee thereof, may not approve the incentive-based compensation arrangement for any covered person identified pursuant to paragraph (b)(3)(ii)(A) of this section unless the board or committee determines that the arrangement, including the method of paying compensation under the arrangement, effectively balances the financial rewards to the covered person and the range and time horizon of risks associated with the covered person's activities, employing appropriate methods for ensuring risk sensitivity, such as deferral of payments, risk adjustment of awards, reduced sensitivity to short-term performance, or longer performance periods; and

(D) In fulfilling its duties under paragraph (b)(3)(ii)(C) of this section, the board of directors, or committee thereof, must evaluate the overall effectiveness of the balancing methods used in the identified covered person's incentive-based compensation arrangements in reducing incentives for inappropriate risk taking by the identified covered person considering the methods' suitability for balancing the full range of risks presented by that covered person's activities, and the methods' ability to make payments sensitive to all the risks arising from the covered person's activities, including those that may be difficult to predict, measure, or model.

§751.6 Policies and procedures.

(a) In general. Any incentive-based compensation arrangement, or any feature of any such arrangement, is prohibited under § 751.5 of this part, unless adopted pursuant to policies and procedures developed and maintained by each credit union and approved by its board of directors, or a committee thereof, reasonably designed to ensure and monitor compliance with the requirements set forth in 12 U.S.C. 5641 and this part and commensurate with the size and complexity of the credit union, as well as the scope and nature of its use of incentive-based compensation.

(b) Standards. The policies and procedures must, at a minimum:

(1) Be consistent with the reporting requirements in § 751.4 of this part and prohibitions in § 751.5 of this part;

(2) Ensure that risk-management, risk-oversight, and internal control personnel have an appropriate role in the credit union's processes for designing incentive-based compensation arrangements and for assessing their effectiveness in restraining inappropriate risk-taking;

(3) Provide for the monitoring by a group or person independent of the covered person, where practicable in light of the credit union's size and complexity, of incentive-based compensation awards and payments, risks taken, and actual risk outcomes to determine whether incentive compensation payments for covered persons, or groups of covered persons, are reduced to reflect adverse risk outcomes or high levels of risk taken;

(4) Provide for the credit union's board of directors, or committee thereof, to receive data and analysis from management and other sources sufficient to allow the board, or committee thereof, to assess whether the overall design and performance of the credit union's incentive-based compensation arrangements are consistent with 12 U.S.C. 5641;

(5) Ensure that documentation of the credit union's processes for establishing, implementing, modifying, and monitoring incentive-based compensation arrangements is maintained that is sufficient to enable the NCUA to determine the credit union's compliance with 12 U.S.C. 5641 and this part;

(6) Consistent with § 751.5(b)(3) of this part, where deferral is used in connection with an incentive-based compensation arrangement, provide for deferral of incentive-based compensation awards in amounts and for periods of time appropriate to the duties

and responsibilities of the credit union's covered persons, the risks associated with those duties and responsibilities, and the size and complexity of the credit union, and provide that the deferral amounts paid are adjusted to reflect actual losses or other measures or aspects of performance that are realized or become better known during the deferral period; and

(7) Subject any incentive-based compensation arrangement to a corporate governance framework that provides for ongoing oversight by the board of directors or a committee thereof, including the approval by the board of directors or a committee thereof of incentive-based compensation to executive officers.

§ 751.7 Evasion.

A credit union is prohibited, for the purpose of evading the restrictions of this part, from doing indirectly or through or by any other person, any act or thing that it would be unlawful for such credit union to do directly under this part.

Securities and Exchange Commission

17 CFR Part 248

Authority and Issuance

For the reasons set forth in the preamble, the Commission proposes to amend Title 17, Chapter II of the Code of Federal Regulations to read as follows:

PART 248 – REGULATION S-P, REGULATION S-AM, AND INCENTIVE-BASED COMPENSATION ARRANGEMENTS

Subpart C – Incentive-based Compensation Arrangements

8. The authority for Part 248 is amended to read as follows:

Authority: 15 U.S.C. 78q, 78q—1, 78w, 78mm, 80a—30, 80a—37, 80b—4, 80b—11, 1681s—3 and note, 1681w(a)(1), 6801-6809, and 6825, and 12 U.S.C. 5641.

9. Add §248.201 through §248.207 to read as follows:

Sec.

* * * * *

§248.201 Authority.

This subpart is issued pursuant to section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. 5641).

§248.202 Scope and purpose.

This subpart applies to a covered financial institution that has total consolidated assets of $1 billion or more and offers incentive-based compensation arrangements to covered persons. Nothing in this subpart in any way limits the authority of the Commission under other provisions of applicable law and regulations.

§248.203 Definitions.

For purposes of this subpart, the following definitions apply unless otherwise specified:

(a) Board of directors means the governing body of any covered financial institution performing functions similar to a board of directors.

(b) Compensation means all direct and indirect payments, fees or benefits, both cash and non-cash, awarded to, granted to, or earned by or for the benefit of, any covered person in exchange for services rendered to the covered financial institution, including, but not limited to, payments or benefits pursuant to an employment contract, compensation or benefit agreement, fee arrangement, perquisite, stock option plan, postemployment benefit, or other compensatory arrangement.

(c) Covered financial institution means: a broker or dealer registered under Section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78o) and an investment adviser as such term is defined in section 202(a)(11) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(11)) that has total consolidated assets of $1 billion or more.

(d) Covered person means any executive officer, employee, director, or principal shareholder of a covered financial institution.

(e) Director of a covered financial institution means a member of the board of directors of the covered financial institution, or of a board or committee performing a similar function to a board of directors.

(f) Executive officer of a covered financial institution means a person who holds the title or, without regard to title, salary, or compensation, performs the function of one or more of the following positions: president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief risk officer, or head of a major business line.

(g) Incentive-based compensation means any variable compensation that serves as an incentive for performance.

(h) Principal shareholder means an individual who directly or indirectly, or acting through or in concert with one or more persons, owns, controls, or has the power to vote 10 percent or more of any class of voting securities of a covered financial institution.

(i) Total consolidated assets means:

(A) For a broker or dealer registered under Section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78o) total assets reported in the firm's most recent year-end audited Consolidated Statement of Financial Condition filed pursuant to Rule 17a-5 under the Securities Exchange Act of 1934; and

(B) For an investment adviser, as such term is defined in section 202(a)(11) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(11)) the adviser's total assets shown on the balance sheet for the adviser's most recent fiscal year end.

§248.204 Required reports to the Commission.

(a) In general. A covered financial institution must submit a report annually to, and in the format directed by, the Commission, that describes the structure of the covered financial institution's incentive-based compensation arrangements for covered persons and that is sufficient to allow an assessment of whether the structure or features of those arrangements provide or are likely to provide covered persons with excessive compensation, fees, or benefits to covered persons or could lead to material financial loss to the covered financial institution.

(b) Individual compensation. A covered financial institution is not required to report the actual compensation of particular covered persons as part of the report required by paragraph (a) of this section.

(c) Minimum standards. The information submitted by the covered financial institution pursuant to paragraph (a) of this section must include the following:

(1) A clear narrative description of the components of the covered financial institution's incentive-based compensation arrangements applicable to covered persons and specifying the types of covered persons to which they apply;

(2) A succinct description of the covered financial institution's policies and procedures governing its incentive-based compensation arrangements for covered persons;

(3) If the covered financial institution has total consolidated assets of $50 billion or more, an additional succinct description of incentive-based compensation policies and procedures specific to the covered financial institution's:

(i) Executive officers; and

(ii) Other covered persons who the board of directors, or a committee thereof, of the covered financial institution has identified and determined under §248.205(b)(3)(ii) of subpart C of this part individually have the ability to expose the covered financial institution to possible losses that are substantial in relation to the covered financial institution's size, capital, or overall risk tolerance;

(4) Any material changes to the covered financial institution's incentive-based compensation arrangements and policies and procedures made since the covered financial institution's last report submitted under paragraph (a) of this section; and

(5) The specific reasons why the covered financial institution believes the structure of its incentive-based compensation plan does not encourage inappropriate risks by the covered financial institution by providing covered persons with:

(i) Excessive compensation; or

(ii) Incentive-based compensation that could lead to a material financial loss to the covered financial institution.

§248.205 Prohibitions.

(a) Excessive compensation prohibition.

(1) In general. A covered financial institution must not establish or maintain any type of incentive-based compensation arrangement, or any feature of any such arrangement, that encourages inappropriate risks by the covered financial institution by providing a covered person with excessive compensation.

(2) Standards. An incentive-based compensation arrangement provides excessive compensation when amounts paid are unreasonable or disproportionate to the services performed by a covered person, taking into consideration:

(i) The combined value of all cash and non-cash benefits provided to the covered person;

(ii) The compensation history of the covered person and other individuals with comparable expertise at the covered financial institution;

(iii) The financial condition of the covered financial institution;

(iv) Comparable compensation practices at comparable covered financial institutions, based upon such factors as asset size, geographic location, and the complexity of the covered financial institution's operations and assets;

(v) For postemployment benefits, the projected total cost and benefit to the covered financial institution;

(vi) Any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the covered financial institution; and

(vii) Any other factors the Commission determines to be relevant.

(b) Material financial loss prohibition.

(1) Generally. A covered financial institution must not establish or maintain any type of incentive-based compensation arrangement, or any feature of any such arrangement, that encourages inappropriate risks by the covered financial institution, by providing incentive-based compensation to covered persons, either individually or as part of a group of persons who are subject to the same or similar incentive-based compensation arrangements, that could lead to material financial loss to the covered financial institution.

(2) Requirements for all covered financial institutions. An incentive-based compensation arrangement established or maintained by a covered financial institution for one or more covered persons does not comply with paragraph (b)(1) of this section unless it:

(i) Balances risk and financial rewards, for example by using deferral of payments, risk adjustment of awards, reduced sensitivity to short-term performance, or longer performance periods;

(ii) Is compatible with effective controls and risk management; and

(iii) Is supported by strong corporate governance, including active and effective oversight by the covered financial institution's board of directors or a committee thereof.

(3) Specific requirements for covered financial institutions with $50 billion or more in total consolidated assets.

(i) Deferral required for executive officers. As part of appropriately balancing risk and financial rewards pursuant to paragraph (b)(2)(i) of this section, any incentive-based compensation arrangement for any executive officer established or maintained by a covered financial institution that has total consolidated assets of $50 billion or more must provide for:

(A) At least 50 percent of the annual incentive-based compensation of the executive officer to be deferred over a period of no less than three years, with the release of deferred amounts to occur no faster than on a pro rata basis; and

(B) The adjustment of the amount required to be deferred under paragraph (b)(3)(i)(A) of this section to reflect actual losses or other measures or aspects of performance that are realized or become better known during the deferral period.

(ii) Additional requirement for covered persons presenting particular loss exposure. As part of appropriately balancing risk and financial rewards pursuant to paragraph (b)(2)(i) of this section, if a covered financial institution has total consolidated assets of $50 billion or more—

(A) The board of directors, or a committee thereof, of the covered financial institution shall identify those covered persons (other than executive officers) who individually have the ability to expose the covered financial institution to possible losses that are substantial in relation to the covered financial institution's size, capital, or overall risk tolerance These covered persons may include, for example, traders with large position limits relative to the covered financial institution's overall risk tolerance and other individuals who have the authority to place at risk a substantial part of the capital of the covered financial institution;

(B) The incentive-based compensation arrangement for any covered person identified pursuant to paragraph (b)(3)(ii)(A) of this section must be approved by the board of directors, or a committee thereof, of the covered financial institution and such approval must be documented;

(C) The board of directors, or committee thereof, may not approve the incentive-based compensation arrangement for any covered person identified pursuant to paragraph (b)(3)(ii)(A) of this section unless the board or committee determines that the arrangement, including the method of paying compensation under the arrangement, effectively balances the financial rewards to the covered person and the range and time horizon of risks associated with the covered person's activities, employing appropriate methods for ensuring risk sensitivity such as deferral of payments, risk adjustment of awards, reduced sensitivity to short-term performance, or longer performance periods; and

(D) In fulfilling its duties under paragraph (b)(3)(ii)(C) of this section, the board of directors or committee thereof must evaluate the overall effectiveness of the balancing methods used in the identified covered person's incentive-based compensation arrangements in reducing incentives for inappropriate risk taking by the identified covered person considering the methods' suitability for balancing the full range of risks presented by that covered person's activities, and the methods' ability to make payments sensitive to all the risks arising from the covered person's activities, including those that may be difficult to predict, measure or model.

§248.206 Policies and procedures.

(a) In general. Any incentive-based compensation arrangement, or any feature of any such arrangement, is prohibited under § 248.205 of this subpart, unless adopted pursuant to policies and procedures developed and maintained by each covered financial institution and approved by its board of directors, or a committee thereof, reasonably designed to ensure and monitor compliance with the requirements set forth in 12 U.S.C. 5641 and subpart C of this part and commensurate with the size and complexity of the organization, as well as the scope and nature of its use of incentive-based compensation.

(b) Standards. The policies and procedures must, at a minimum:

(1) Be consistent with the reporting requirements in § 248.204 of subpart C of this part and prohibitions in § 248.205 of subpart C of this part;

(2) Ensure that risk-management, risk-oversight, and internal control personnel have an appropriate role in the covered financial institution's processes for designing incentive-based compensation arrangements and for assessing their effectiveness in restraining inappropriate risk-taking;

(3) Provide for the monitoring by a group or person independent of the covered person, where practicable in light of the covered financial institution's size and complexity, of incentive-based compensation awards and payments, risks taken, and actual risk outcomes to determine whether incentive-based compensation payments for

covered persons, or groups of covered persons, are reduced to reflect adverse risk outcomes or high levels of risk taken;

(4) Provide for the covered financial institution's board of directors, or committee thereof, to receive data and analysis from management and other sources sufficient to allow the board, or committee thereof, to assess whether the overall design and performance of the covered financial institution's incentive-based compensation arrangements are consistent with 12 U.S.C. 5641;

(5) Ensure that documentation of the covered financial institution's processes for establishing, implementing, modifying, and monitoring incentive-based compensation arrangements is maintained that is sufficient to enable the Commission to determine the covered financial institution's compliance with 12 U.S.C. 5641 and subpart C of this part;

(6) Consistent with § 248.205(b)(3) of subpart C, where deferral is used in connection with an incentive-based compensation arrangement, provide for deferral of incentive-based compensation awards in amounts and for periods of time appropriate to the duties and responsibilities of the covered financial institution's covered persons, the risks associated with those duties and responsibilities, and the size and complexity of the covered financial institution and provide that the deferral amounts paid are adjusted to reflect actual losses or other measures or aspects of performance that are realized or become better known during the deferral period; and

(7) Subject any incentive-based compensation arrangement to a corporate governance framework that provides for ongoing oversight by the board of directors or a committee thereof, including the approval by the board of directors or a committee thereof of incentive-based compensation to executive officers.

§ 248.207 Evasion.

A covered financial institution is prohibited, for the purpose of evading the restrictions of this subpart, from doing indirectly or through or by any other person, any act or thing that it would be unlawful for such covered financial institution to do directly under this subpart.

Federal Housing Finance Agency

Authority and Issuance

Accordingly, for the reasons stated in the preamble, under the authority of 12 U.S.C. 4526 and 5641, FHFA proposes to amend Chapter XII of title 12 of the Code of Federal Regulations to read as follows:

10. Part 1232 to Subchapter B is added to read as follows:

PART 1232—INCENTIVE-BASED COMPENSATION AGREEMENTS

Sec.

Authority: 12 U.S.C. 4511(b), 4513, 4514, 4526, and 5641.

§ 1232.1 Authority.

This part is issued pursuant to section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. 5641), and, with respect to the Office of Finance, under section 1311(b)(2) of the Federal Housing Enterprises Financial Safety and Soundness Act (12 U.S.C. 4511(b)(2)).

§ 1232.2 Scope and purpose.

This part applies to a covered entity that offers incentive-based compensation arrangements to covered persons. Nothing in this part in any way limits the authority of the Federal Housing Finance Agency under other provisions of applicable law and regulations.

§ 1232.3 Definitions.

For purposes of this part, the following definitions apply unless otherwise specified:

Board of directors means the governing body of any covered entity performing functions similar to a board of directors.

Compensation means all direct and indirect payments, fees or benefits, both cash and non-cash, awarded to, granted to, or earned by or for the benefit of, any covered person in exchange for services rendered to the covered entity, including, but not limited to, payments or benefits pursuant to an employment contract, compensation or benefit agreement, fee arrangement, perquisite, stock option plan, postemployment benefit, or other compensatory arrangement.

Covered entity means the Federal National Mortgage Association (Fannie Mae); the Federal Home Loan Mortgage Corporation (Freddie Mac); any Federal Home Loan Bank (Bank); and the Federal Home Loan Bank System's Office of Finance.

Covered person means any executive officer, employee, director, or principal shareholder of a covered entity.

Director of a covered entity means a member of the board of directors of the covered entity, or of a board or committee performing a similar function to a board of directors.

Executive officer of a covered entity means:

(1) With respect to Fannie Mae or Freddie Mac:

(i) The chairman of the board of directors, chief executive officer, chief financial officer, chief operating officer, president, vice chairman, any executive vice president, any senior vice president in charge of a principal business unit, division, or function and any individual who performs functions similar to such positions whether or not the individual has an official title; and

(ii) Any other officer as identified by the Director.

(2) With respect to a Bank:

(i) The president, the chief financial officer, and the three other most highly compensated officers; and

(ii) Any other officer as identified by the Director.

(3) With respect to the Office of Finance:

(i) The chief executive officer, chief financial officer, and chief operating officer; and

(ii) Any other officer identified by the Director.

Incentive-based compensation means any variable compensation that serves as an incentive for performance.

Principal shareholder means an individual who directly or indirectly, or acting through or in concert with one or more persons, owns, controls, or has the power to vote 10 percent or more of any class of voting securities of a covered entity.

§ 1232.4 Required reports to regulators.

(a) In general. A covered entity must submit a report annually to, and in the format directed by, the Federal Housing Finance Agency that describes the structure of the covered entity's incentive-based compensation arrangements for covered persons and that is sufficient to allow an assessment of whether the structure or features of those arrangements provide or are likely to provide covered persons with excessive compensation, fees, or benefits to covered persons or could lead to material financial loss to the covered entity.

(b) Individual compensation. A covered entity is not required to report the actual compensation of particular covered persons as part of the report required by paragraph (a) of this section.

(c) Minimum standards. The information submitted by the covered entity pursuant to paragraph (a) of this section must include the following:

(1) A clear narrative description of the components of the covered entity's incentive-based compensation arrangements applicable to covered persons specifying the types of covered persons to which they apply;

(2) A succinct description of the covered entity's policies and procedures governing its incentive-based compensation arrangements for covered persons;

(3) A succinct description of incentive-based compensation policies and procedures specific to the covered entity's:

(i) Executive officers; and

(ii) Other covered persons who the board of directors, or a committee thereof, of the entity has identified and determined under § 1232.5(b)(3)(ii) of this part individually have the ability to expose the entity to possible losses that are substantial in relation to the entity's size, capital, or overall risk tolerance;

(4) Any material changes to the covered entity's incentive-based compensation arrangements and policies and procedures made since the covered entity's last report submitted under paragraph (a) of this section; and

(5) The specific reasons why the covered entity believes the structure of its incentive-based compensation plan does not encourage inappropriate risks by the covered entity by providing covered persons with:

(i) Excessive compensation; or

(ii) Incentive-based compensation that could lead to material financial loss to the covered entity.

§ 1232.5 Prohibitions.

(a) Excessive compensation prohibition. (1) In general. A covered entity must not establish or maintain any type of incentive-based compensation arrangement, or any feature of any such arrangement, that encourages inappropriate risks by the covered entity by providing a covered person with excessive compensation.

(2) Standards. An incentive-based compensation arrangement provides excessive compensation when amounts paid are unreasonable or disproportionate to the services performed by a covered person, taking into consideration:

(i) The combined value of all cash and non-cash benefits provided to the covered person;

(ii) The compensation history of the covered person and other individuals with comparable expertise at the covered entity;

(iii) The financial condition of the covered entity;

(iv) Comparable compensation practices at comparable institutions, based upon such factors as asset size, geographic location, and the complexity of the institution's operations and assets;

(v) For postemployment benefits, the projected total cost and benefit to the covered entity;

(vi) Any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the covered entity; and

(vii) Any other factors that the Federal Housing Finance Agency determines to be relevant.

(b) Material financial loss prohibition. (1) Generally. A covered entity must not establish or maintain any type of incentive-based compensation arrangement, or any feature of any such arrangement, that encourages inappropriate risks by the covered entity, by providing incentive-based compensation to covered persons, either individually, or as part of a group of persons who are subject to the same or similar incentive-based compensation arrangements, that could lead to material financial loss to the covered entity.

(2) Requirements for all incentive-based compensation arrangements. An incentive-based compensation arrangement established or maintained by a covered entity for one or more covered persons does not comply with paragraph (b)(1) of this section unless it:

(i) Balances risk and financial rewards, for example by using deferral of payments, risk adjustment of awards, reduced sensitivity to short-term performance, or longer performance periods;

(ii) Is compatible with effective controls and risk management; and

(iii) Is supported by strong corporate governance, including active and effective oversight by the covered entity's board of directors, or a committee thereof.

(3) Requirements for executive officers and covered persons presenting particular loss exposure.

(i) Deferral required for executive officers. As part of appropriately balancing risk and financial rewards pursuant to paragraph (b)(2)(i) of this section, any incentive-based compensation arrangement for any executive officer established or maintained by a covered entity (except for covered entities in conservatorship or receivership, and limited-life regulated entities) must provide for:

(A) At least 50 percent of the annual incentive-based compensation of the executive officer to be deferred over a period of no less than three years, with the release of deferred amounts to occur no faster than on a pro rata basis; and

(B) The adjustment of the amount required to be deferred under paragraph (b)(3)(i)(A) of this section to reflect actual losses or other measures or aspects of performance that are realized or become better known during the deferral period.

(ii) Additional requirement for covered persons presenting particular loss exposure. As part of appropriately balancing risk and financial rewards pursuant to paragraph (b)(2)(i) of this section:

(A) The board of directors, or a committee thereof, of the covered entity shall identify those covered persons (other than executive officers) who individually have the ability to expose the entity to possible losses that are substantial in relation to the entity's size, capital, or overall risk tolerance. These covered persons may include, for example, traders with large position limits relative to the entity's overall risk tolerance and other individuals who have the authority to place at risk a substantial part of the capital of the covered entity;

(B) The incentive-based compensation arrangement for any covered person identified pursuant to paragraph (b)(3)(ii)(A) of this section must be approved by the board of directors, or a committee thereof, of the covered entity and such approval must be documented;

(C) The board of directors, or a committee thereof, may not approve the incentive-based compensation arrangement for any covered person identified pursuant to paragraph (b)(3)(ii)(A) of this section unless the board or committee determines that the arrangement, including the method of paying compensation under the arrangement, effectively balances the financial rewards to the covered person and the range and time horizon of risks associated with the covered person's activities, employing appropriate methods for ensuring risk sensitivity such as deferral of payments, risk adjustment of awards, reduced sensitivity to short-term performance, or longer performance periods; and

(D) In fulfilling its duties under paragraph (b)(3)(ii)(C) of this section, the board of directors, or a committee thereof, must evaluate the overall effectiveness of the balancing methods used in the identified covered person's incentive compensation arrangements in reducing incentives for inappropriate risk taking by the identified covered person considering the methods' suitability for balancing the full range of risks presented by that covered person's activities, and the methods' ability to make payments sensitive to all the risks arising from the covered person's activities, including those that may be difficult to predict, measure or model.

§ 1232.6 Policies and procedures.

(a) In general. Any incentive-based compensation arrangement, or any feature of any such arrangement, is prohibited under § 1232.5 of this part, unless adopted pursuant to policies and procedures developed and maintained by each covered entity and approved by its board of directors, or a committee thereof, reasonably designed to ensure and monitor compliance with the requirements set forth in 12 U.S.C. 5641 and this part and commensurate with the size and complexity of the organization, as well as the scope and nature of its use of incentive-based compensation.

(b) Standards. The policies and procedures must, at a minimum:

(1) Be consistent with the reporting requirements in § 1232.4 of this part and prohibitions in § 1232.5 of this part;

(2) Ensure that risk-management, risk-oversight, and-internal control personnel have an appropriate role in the covered entity's processes for designing incentive-based compensation arrangements and for assessing their effectiveness in restraining inappropriate risk-taking;

(3) Provide for the monitoring by a group or person independent of the covered person, where practicable in light of the covered entity's size and complexity, of incentive-based compensation awards and payments, risks taken, and actual risk

outcomes to determine whether incentive compensation payments for covered persons, or groups of covered persons, are reduced to reflect adverse risk outcomes or high levels of risk taken;

(4) Provide for the covered entity's board of directors, or committee thereof, to receive data and analysis from management and other sources sufficient to allow the board, or committee thereof, to assess whether the overall design and performance of the entity's incentive-based compensation arrangements are consistent with 12 U.S.C. 5641;

(5) Ensure that documentation of the entity's processes for establishing, implementing, modifying, and monitoring incentive-based compensation arrangements is maintained that is sufficient to enable the Federal Housing Finance Agency to determine the entity's compliance with 12 U.S.C. 5641 and this part;

(6) Consistent with § 1232.5(b)(3) of this part, where deferral is used in connection with an incentive-based compensation arrangement, provide for deferral of incentive-based compensation awards in amounts and for periods of time appropriate to the duties and responsibilities of the covered entity's covered persons, the risks associated with those duties and responsibilities, and the size and complexity of the covered entity and provide that the deferral amounts paid are adjusted to reflect actual losses or other measures or aspects of performance that are realized or become better known during the deferral period; and

(7) Subject any incentive-based compensation arrangement to a corporate governance framework that provides for ongoing oversight by the board of directors, or a committee thereof, including the approval by the board of directors, or a committee thereof, of incentive-based compensation to executive officers.

§ 1232.7 Evasion.

A covered entity is prohibited, for the purpose of evading the restrictions of this part, from doing indirectly or through or by any other person, any act or thing that it would be unlawful for such covered entity to do directly under this part.

Dated: March 4, 2011

John Walsh,
Acting Comptroller of the Currency

By order of the Board of Governors of the Federal Reserve System, March 30, 2011.

Jennifer J. Johnson,
Secretary of the Board.

Dated at Washington, D.C., this 7th day of February, 2011.
FEDERAL DEPOSIT INSURANCE CORPORATION

Robert E. Feldman
Executive Secretary

Dated: February 18, 2011
By the Office of Thrift Supervision,

John E. Bowman,
Acting Director.

By the National Credit Union Administration Board on February 17, 2011.

Mary F. Rupp
Secretary of the Board

By the Commission.

____
Elizabeth M. Murphy
Secretary, Securities and Exchange Commission
Date: March 29, 2011

____
Edward J. Demarco,
Acting Director, Federal Housing Finance Agency

March 10, 2011
Date

[THIS SIGNATURE PAGE PERTAINS TO THE PROPOSED RULE ENTITLED

"Incentive-based Compensation Arrangements"]

Dated: 3-4-11

John Walsh

John Walsh,
Acting Comptroller of the Currency

[THIS SIGNATURE PAGE PERTAINS TO THE JOINT PROPOSED RULE ENTITLED "INCENTIVE-BASED COMPENSATION ARRANGEMENTS".]

By order of the Board of Governors of the Federal Reserve System, March 30, 2011.

Jennifer J. Johnson

Jennifer J. Johnson
Secretary of the Board.

[THIS SIGNATURE PAGE PERTAINS TO THE JOINT PROPOSED RULE ENTITLED "INCENTIVE-BASED COMPENSATION ARRANGEMENTS".]

Dated at Washington, D.C., this 7th day of February, 2011.

FEDERAL DEPOSIT INSURANCE CORPORATION

Robert E. Feldman

Executive Secretary

BILLING CODE: **[6741-01-P]**

[THIS SIGNATURE PAGE PERTAINS TO THE JOINT PROPOSED RULE ENTITLED "INCENTIVE-BASED COMPENSATION ARRANGEMENTS."]

Dated: FEB 18 2011

By the Office of Thrift Supervision,

John E. Bowman

John E. Bowman,
Acting Director.

[THIS SIGNATURE PAGE PERTAINS TO THE INTERAGENCY PROPOSED RULE ENTITLED "INCENTIVE-BASED COMPENSATION ARRANGEMENTS".]

By the NATIONAL CREDIT UNION ADMINISTRATION Board on February 17, 2011

Mary F. Rupp

Mary F. Rupp

Secretary of the Board

[THIS SIGNATURE PAGE PERTAINS TO THE SECURITIES AND EXCHANGE COMMISSION'S PORTION OF THE JOINT PROPOSED RULES ENTITLED "INCENTIVE BASED COMPENSATION ARRANGEMENTS".]

By the Securities and Exchange Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Date: March 29, 2011

Billing code: 8011-01p

[THIS SIGNATURE PAGE PERTAINS TO THE JOINT PROPOSED RULE ENTITLED "INCENTIVE-BASED COMPENSATION ARRANGEMENTS".]

Edward J. DeMarco

Edward J. DeMarco,
Acting Director, Federal Housing Finance Agency.
BILLING CODE: [8070-01-P]

3/10/2011
Date