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A cumulative list of the parts affected this month can be found in the Reader Aids section at the end of this issue.

Rules and Regulations

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This section of the FEDERAL REGISTER contains regulatory documents having general applicability and legal effect, most of which are keyed to and codified in the Code of Federal Regulations, which is published under 50 titles pursuant to 44 U.S.C. 1510.

The Code of Federal Regulations is sold by the Superintendent of Documents. Prices of new books are listed in the first FEDERAL REGISTER issue of each week.

DEPARTMENT OF AGRICULTURE

Animal and Plant Health Inspection Service

9 CFR Part 82

[Docket No. 02–117–9]

Exotic Newcastle Disease; Removal of Areas From Quarantine

AGENCY: Animal and Plant Health Inspection Service, USDA.

ACTION: Interim rule and request for comments.

SUMMARY: We are amending the exotic Newcastle disease regulations by removing portions of Arizona, California, Nevada, and Texas from the list of quarantined areas. This action removes restrictions on the movement of birds, poultry, and certain other articles from those areas. With this action, there are no longer any areas in Arizona, Nevada, and Texas that are quarantined because of exotic Newcastle disease, and the size of the quarantined area in California is reduced.

DATES: This interim rule was effective July 30, 2003. We will consider all comments that we receive on or before October 3, 2003.

ADDRESSES: You may submit comments by postal mail/commercial delivery or by e-mail. If you use postal mail/commercial delivery, please send four copies of your comment (an original and three copies) to: Docket No. 02–117–9, Regulatory Analysis and Development, PPD, APHIS, Station 3C71, 4700 River Road Unit 118, Riverdale, MD 20737–1238. Please state that your comment refers to Docket No. 02–117–9. If you use e-mail, address your comment to *regulations@aphis.usda.gov.* Your comment must be contained in the body of your message; do not send attached files. Please include your name and address in your message and ''Docket No. 02–117–9'' on the subject line.

You may read any comments that we receive on this docket in our reading room. The reading room is located in room 1141 of the USDA South Building, 14th Street and Independence Avenue SW., Washington, DC. Normal reading room hours are 8 a.m. to 4:30 p.m., Monday through Friday, except holidays. To be sure someone is there to help you, please call (202) 690–2817 before coming.

APHIS documents published in the **Federal Register**, and related information, including the names of organizations and individuals who have commented on APHIS dockets, are available on the Internet at *http://www.aphis.usda.gov/ppd/rad/webrepor.html.*

FOR FURTHER INFORMATION CONTACT: Dr. Aida Boghossian, Senior Staff Veterinarian, Emergency Programs Staff, VS, APHIS, 4700 River Road Unit 41, Riverdale, MD 20737–1231; (301) 734–8073.

SUPPLEMENTARY INFORMATION:

Background

Exotic Newcastle disease (END) is a contagious and fatal viral disease affecting the respiratory, nervous, and digestive systems of birds and poultry. END is so virulent that many birds and poultry die without showing any clinical signs. A death rate of almost 100 percent can occur in unvaccinated poultry flocks. END can infect and cause death even in vaccinated poultry.

The regulations in ''Subpart A—Exotic Newcastle Disease (END)'' (9 CFR 82.1 through 82.16, referred to below as the regulations) were established to prevent the spread of END in the United States in the event of an outbreak. In § 82.3, paragraph (a) provides that any area where birds or poultry infected with END are located will be designated as a quarantined area, and that a quarantined area is any geographical area, which may be a premises or all or part of a State, deemed by epidemiological evaluation to be sufficient to contain all birds or poultry known to be infected with or exposed to END.

Prior to the effective date of this interim rule, portions of Arizona, California, Nevada, and Texas were designated as quarantined areas in § 82.3(c) of the regulations. As a result, the interstate movement from those quarantined areas of birds, poultry, products, and materials that could spread END was prohibited or restricted. Further, because the Secretary of Agriculture declared an extraordinary emergency because of END in those States, the intrastate movement from the quarantined areas of birds, poultry, products, and materials that could spread END was prohibited or restricted, as provided by the regulations in § 82.16.

Quarantine Actions in California

On October 1, 2002, END was confirmed in the State of California. The disease was confirmed in backyard poultry, which are raised on private premises for hobby, exhibition, and personal consumption. Consequently, in an interim rule effective on November 21, 2002, and published in the **Federal Register** on November 26, 2002 (67 FR 70674–70675, Docket No. 02–117–1), we amended the regulations in § 82.3(c) by designating Los Angeles County, CA, and portions of Riverside and San Bernardino Counties, CA, as quarantined areas.

Subsequent detections of END in backyard and commercial poultry on other premises in California led us to further amend § 82.3(c) in order to quarantine additional areas in that State. Specifically:

- In an interim rule effective on January 7, 2003, and published in the **Federal Register** on January 13, 2003 (68 FR 1515–1517, Docket No. 02–117–2), we added Imperial, Orange, San Diego, Santa Barbara, and Ventura Counties, CA, and the previously non-quarantined portions of Riverside and San Bernardino Counties, CA, to the list of quarantined areas.
- In an interim rule effective on May 13, 2003, and published in the **Federal Register** on May 19, 2003 (68 FR 26988–26990, Docket No. 02–117–7), we added a portion of Kern County, CA, to the list of quarantined areas.

As provided for by the regulations in § 82.3(a), these quarantined areas in California encompassed each area where poultry infected with END were located and a surrounding geographical area deemed by epidemiological evaluation to be sufficient to contain all birds or poultry known to be infected with or exposed to END.

Quarantine Actions in Arizona, Nevada, and Texas

In addition to the detections of END in California, the disease was also confirmed in backyard poultry on premises in three other States: In Nevada on January 16, 2003; in Arizona on February 4, 2003; and in Texas on April 9, 2003. Shortly after each of those confirmations, we responded by publishing an interim rule amending § 82.3(c) to designate areas surrounding the affected premises as quarantined areas. Specifically:

• In interim rule effective January 17, 2003, and published in the **Federal Register** on January 24, 2003 (68 FR 3375–3376, Docket No. 02–117–3), we designated all of Clark County, NV, and a portion of Nye County, NV, as a quarantined area;

• In an interim rule effective February 10, 2003, and published in the **Federal Register** on February 14, 2003 (68 FR 7412–7413, Docket No. 02–117–4), we designated La Paz and Yuma Counties, AZ, and a portion of Mohave County, AZ, as a quarantined area; and

• In an interim rule effective April 10, 2003, and published in the **Federal Register** on April 16, 2003 (68 FR 18531–18532, Docket No. 02–117–5), we designated El Paso and Hudspeth Counties, TX, and Dona Ana, Luna, and Otero Counties, NM, as a quarantined area.

As was the case with California, the areas Arizona, Nevada, and Texas that were quarantined in those interim rules encompassed each area where poultry infected with END were located and a surrounding geographical area deemed by epidemiological evaluation to be sufficient to contain all birds or poultry known to be infected with or exposed to END, as provided for by the regulations in § 82.3(a).

Previous Reductions in Quarantined Areas

After evaluating the results of extensive investigations conducted in Arizona, Nevada, New Mexico, and Texas, APHIS epidemiologists determined it was possible to reduce the size of the quarantined areas in those States by eliminating areas in which END had not been found. Thus, in an interim rule effective May 14, 2003, and published in the **Federal Register** on May 19, 2003 (69 FR 26986–26988, Docket No. 02–117–6), we amended the regulations in § 82.3(c) by reducing the size of the quarantined areas in Nevada and Arizona, leaving only portions of La Paz County, AZ, and Clark County, NV, as quarantined areas in those States. Similarly, in another interim rule effective June 5, 2003, and published in the **Federal Register** on June 11, 2003 (69 FR 34779–34781, Docket No. 02–117–8), we amended the regulations in § 82.3(c) by reducing the size of the quarantined areas in Texas and eliminating the quarantined areas in New Mexico, leaving only a portion of El Paso County, TX, as a quarantined area in that State.

Additional Reductions in Quarantined Areas

In this interim rule, we are reducing the size of the quarantined area in California and eliminating the last remaining quarantined areas in Arizona, Nevada, and Texas. Except for portions of San Diego County, the areas we are removing from quarantine in California are areas in which END has not been found after extensive surveillance. Our actions with respect to La Paz County, AZ, Clark County, NV, El Paso County, TX, and the remaining portions of San Diego County, CA—areas that had, at one time, contained infected premises—are based upon our determination that those areas meet the criteria contained in § 82.14 of the regulations for release from quarantine. Our basis for these actions is discussed in greater detail below.

Areas in Which END Has Not Been Found

No END-positive premises were detected in Imperial, Orange, or Santa Barbara Counties, CA, or in large areas of Kern, Los Angeles, Riverside, San Bernardino, San Diego, and Ventura Counties, CA. Large parts of these areas are made up of public lands or mountains, desert, or other largely uninhabited terrain. Intense surveillance and testing of both noncommercial and commercial poultry premises was carried out in these areas, also known as the surveillance zone, and resulted in no END-positive premises being detected.

Noncommercial premises. An inventory of at-risk noncommercial premises was developed for the areas targeted for quarantine release. In addition to information previously collected through eradication activities, sources of information included local animal control authorities, local law enforcement, county agricultural officials, extension personnel, and animal welfare workers.

Surveillance efforts were concentrated in areas that had at-risk premises. An at-risk premises was defined as a premises inhabited by poultry, ratites, or an aviary. Within this population, premises considered highest risk were targeted for sampling. High risk premises were defined as any premises with any galliform birds (chickens, turkeys, pheasant, quail, partridge, guinea fowl, pea fowl, *etc.*), columbiform birds (pigeons, doves), or anseriform birds (ducks, geese, swans). Other factors considered to indicate high risk were multiple owners on the same premises, premises with sick or dead birds, history of movement of birds, and possible contact with an infected premises.

The sampling period was concentrated from March through June 2003, but began as early as January 2003. All sampling of the surveillance zone was completed by early July 2003. At least 6,917 premises with birds were identified in the surveillance zone. The true total number of premises with birds in the surveillance zone is not known, but efforts were made to identify the areas most likely to have at-risk premises.

Overall, a total of 1,811 at-risk premises were sampled from a population of 3,386 at-risk premises in the surveillance zone. Over 23,600 birds were sampled and tested for END virus. None of the samples yielded a positive result.

TABLE 1.—AT-RISK NONCOMMERCIAL PREMISES SAMPLED BY COUNTY IN CALIFORNIA

County	Number of premises sampled	County	Number of premises sampled
Imperial	182	San Bernardino	124
Kern	15	San Diego	343
Los Angeles	39	Santa Barbara	349
Orange	256	Ventura	274
Riverside	229		

Commercial premises. Active weekly surveillance of commercial poultry premises in the surveillance zone began in January 2003. All commercial premises with chickens were under weekly active surveillance beginning April 10, 2003, or earlier. All commercial premises have a documented biosecurity protocol in place. Also, these premises must report any significant increase in death losses or the occurrences of clinical signs consistent with END.

A total of 29 commercial poultry premises were located in the surveillance zone in California, of which 17 premises had birds present. The total estimated number of commercial birds on the 17 premises was over 1 million. The other commercial premises were either egg processors, manure haulers, or were void of birds and therefore did not participate in active surveillance. A representative sampling of either live or dead birds from each poultry house was done weekly. Sample collection was done by either an accredited veterinarian or authorized company personnel. No END positive premises were found.

As noted previously, the regulations in § 82.3(a) provide that any area where birds or poultry infected with END are located will be designated as a quarantined area, and that a quarantined area is any geographical area, which may be a premises or all or part of a State, deemed by epidemiological evaluation to be sufficient to contain all birds or poultry known to be infected with or exposed to END.

Animal and Plant Health Inspection Service (APHIS) epidemiologists have evaluated the results of the investigations conducted in California and have determined that we may now reduce the size of the quarantined area in that State. This determination is based on, among other things, the demonstrated absence of birds or poultry infected with or exposed to END in specific areas. The regulations in § 82.14 provide requirements that must be met before an area may be removed from quarantine, but those requirements relate to measures taken with respect to END-infected or -exposed birds and poultry, their eggs and manure, and articles and premises with which such birds or their manure or litter have come in contact. As there were no END-infected or -exposed birds or poultry in Imperial, Orange,[1] and Santa Barbara Counties, CA, or in portions of Kern, Los Angeles, Riverside, San Bernardino, San Diego, and Ventura Counties, CA, there are no requirements under § 82.14 that need to be met before those areas can be removed from quarantine.

Areas That Contained Infected Premises

An area where END positive premises have been detected is known as an ''infected area.'' The infected area in Arizona and in Texas each had one END positive premises. The infected area in Nevada had 10 positive premises detected. None of the infected premises in those three States were commercial poultry premises. The infected area of San Diego County, CA, had 20 infected premises, 7 of which were commercial poultry premises. All birds on all infected premises, and any premises exposed to those infected premises, were depopulated. The date of depopulation on the final END positive premises in each infected area was:

• Clark County, NV: January 29, 2003;
• La Paz County, AZ: February 7, 2003;
• El Paso County, TX: April 7, 2003; and
• San Diego County, CA: April 21, 2003.

Intensive surveillance and testing of both noncommercial and commercial poultry premises was carried out in the infected areas and resulted in no additional END positive premises being detected.

Noncommercial premises. An inventory of at-risk noncommercial premises was developed for the infected areas. Surveillance efforts were then concentrated in portions of the infected areas that had at-risk premises. An at-risk premises was defined as a premises inhabited by poultry, ratites, or an aviary. Within this population, premises considered highest risk were targeted for sampling.

Results of the surveillance conducted in the infected areas in Arizona, Nevada, and Texas were reported in our interim rules of May 19, 2003 (for Arizona and Nevada), and June 11, 2003 (for Texas), cited previously. None of the samples collected was positive for END virus.

In the infected area of San Diego County, CA, all of the sampling was conducted during the 6-week period from June 1 through July 12, 2003. The majority of the sampling of premises was conducted during a 2-week period from June 22 to July 5, 2003. At least 1,126 premises with birds were identified in the area. The true total number of premises with birds in the area is not known, but efforts were made to identify the areas most likely to have at-risk premises.

Overall, a total of 539 at-risk premises were sampled from a population of 701 at-risk premises in the infected area of San Diego County, CA. Over 5,100 birds were sampled and tested for END virus. None of the samples yielded a positive result.

Commercial premises. Active weekly surveillance of commercial poultry premises in the infected area of San Diego County, CA, began in February 2003. All commercial premises with birds have been under weekly active surveillance for at least 6 weeks and have a documented biosecurity protocol in place. Also, these premises must report any significant increase in death losses or the occurrences of clinical signs consistent with END.

A total of 30 commercial poultry premises are located in the infected area, of which 22 premises had birds present. The eight other commercial premises are egg processors and did not participate in active surveillance. Seven of the 22 premises with birds were found to be infected and were depopulated. Two other premises are now void of birds. A representative sampling of either live or dead birds from each poultry house on the remaining 13 premises with birds was performed weekly. Sample collection was done by either an accredited veterinarian or authorized company personnel. No END positive premises were found.

We have determined that all applicable requirements of § 82.14 to remove an area from quarantine have been met with respect to the remaining areas in La Paz County, AZ, San Diego County, CA, Clark County, NV, and El Paso County. Specifically, we have determined the following:

• All birds and poultry exposed to END have been found to be free of END;
• All birds and poultry infected with END have been euthanized;
• All parts of all birds and poultry that were euthanized or that died from any cause other than slaughter, all eggs produced by birds or poultry infected with or exposed to END, and all manure generated by and litter used by birds or poultry infected with or exposed to END have been buried at least 6 feet deep and covered at the time of burial with soil in a location within the quarantined area that meets all U.S. Environmental Protection Agency (EPA), State, and local requirements for landfills;
• All vehicles with which the birds or poultry infected with or exposed to END or their excrement or litter have had physical contact have been cleaned and

[1] Although there were no infected premises in Orange County, a portion of that county will remain as a quarantined area due to its proximity to areas in adjoining counties where infected premises were found.

disinfected in the manner prescribed in § 82.14(f);

- All cages, coops, containers, troughs, and other equipment used for birds or poultry infected with or exposed to END or their excrement or litter have been reduced to ashes by incineration or have been cleaned and disinfected in the manner prescribed in § 82.14(g); and
- The premises where birds or poultry infected with or exposed to END were located have been cleaned and disinfected in the manner prescribed in § 82.14(h).

Conclusion

Based on the information presented above, we are amending § 82.3(c) in this interim rule by removing Imperial and Santa Barbara Counties, CA, and portions of Kern, Los Angeles, Orange, Riverside, San Bernardino, San Diego, and Ventura Counties, CA, from the list of quarantined areas because the continued quarantine of these areas is no longer necessary to contain all birds and poultry infected with or exposed to END. Those portions of Kern, Los Angeles, Orange,[2] Riverside, San Bernardino, and Ventura Counties, CA, that will remain as quarantined areas, which are described in the amendments to § 82.3(c) at the end of this document, have been deemed by epidemiological evaluation to be sufficient to contain all birds or poultry known to be infected with or exposed to END. In addition, we are also amending the regulations in § 82.3(c) by removing the remaining portions of La Paz County, AZ, San Diego County, CA, Clark County, NV, and El Paso County, TX, from the list of quarantined areas based on our determination that the requirements of § 82.14 have been met with respect to those areas. With this action, there are no longer any areas in Arizona, Nevada, and Texas that are quarantined because of END, and the size of the quarantined area in California is reduced.

Immediate Action

Immediate action is warranted to relieve restrictions that are no longer necessary. We have determined that portions of Arizona, California, Nevada, and Texas may now be removed from the list of areas quarantined because of END. Therefore, immediate action is warranted to relieve the prohibitions or restrictions that have applied to the movement of birds, poultry, products, and other materials from those areas. Under these circumstances, the Administrator has determined that prior notice and opportunity for public comment are contrary to the public interest and that there is good cause under 5 U.S.C. 553 for making this action effective less than 30 days after publication in the **Federal Register**.

We will consider comments that we receive during the comment period for this interim rule (*see* DATES above). After the comment period closes, we will publish another document in the **Federal Register**. The document will include a discussion of any comments we receive and any amendments we are making to the rule.

Executive Order 12866 and Regulatory Flexibility Act

This rule has been reviewed under Executive Order 12866. For this action, the Office of Management and Budget has waived its review under Executive Order 12866.

This rule amends the regulations by removing portions of Arizona, California, Nevada, and Texas from the list of quarantined areas. This action needs to be made effective immediately in order to remove restrictions on the movement of birds, poultry, and certain other articles from those areas that are no longer necessary.

This situation makes timely compliance with section 604 of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) impracticable. We are currently assessing the potential economic effects of this action on small entities. Based on that assessment, we will either certify that the rule will not have a significant economic impact on a substantial number of small entities or publish a final regulatory flexibility analysis.

Executive Order 12372

This program/activity is listed in the Catalog of Federal Domestic Assistance under No. 10.025 and is subject to Executive Order 12372, which requires intergovernmental consultation with State and local officials. (*See* 7 CFR part 3015, subpart V.)

Executive Order 12988

This rule has been reviewed under Executive Order 12988, Civil Justice Reform. This rule: (1) Preempts all State and local laws and regulations that are in conflict with this rule; (2) has no retroactive effect; and (3) does not require administrative proceedings before parties may file suit in court challenging this rule.

Paperwork Reduction Act

This interim rule contains no information collection or recordkeeping requirements under the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 *et seq.*).

List of Subjects in 9 CFR Part 82

Animal diseases, Poultry and poultry products, Quarantine, Reporting and recordkeeping requirements, Transportation.

■ Accordingly, 9 CFR part 82 is amended as follows:

PART 82—EXOTIC NEWCASTLE DISEASE (END) AND CHLAMYDIOSIS

■ 1. The authority citation for part 82 continues to read as follows:

Authority: 7 U.S.C. 8301–8317; 7 CFR 2.22, 2.80, and 371.4.

■ 2. In § 82.3, paragraph (c), the entries for Arizona, Nevada, and Texas are removed and the entry for California is revised to read as follows:

§ 82.3 Quarantined areas.

* * * * *

(c) * * *

California

Kern County. That portion of the county bounded by a line drawn as follows: Beginning on the Kern/Los Angeles County line at the point where the county line is intersected by an imaginary line running northeast from the intersection of State Highway 126 and the Los Angeles/Ventura County line to the intersection of Tehachapi Willow Springs Road and West 100th Street in the city of Mojave; then northeast along that same imaginary line to the intersection of Tehachapi Willow Springs Road and West 100th Street in the city of Mojave; then north on West 100th Street to Laguna Street; then east on Laguna Street to West 90th Street; then north on West 90th Street to Oak Creek Road; then east on Oak Creek Road to State Highway 14; then south on State Highway 14 to State Highway 58; then east on State Highway 58 to East 30th Street in the city of Mojave; then southeast from that point along an imaginary line to the southeastern corner of Kern County; then west along the Kern/San Bernardino County line to the Kern/Los Angeles County line; then west along the Kern/Los Angeles County line to the point of beginning.

Los Angeles County. That portion of the county bounded by a line drawn as follows: Beginning at the intersection of the Los Angeles/Orange County line and East Willow Street in the city of Long Beach; then west along East Willow Street, West Willow Street, East Sepulveda Boulevard, West Sepulveda Boulevard, and Sepulveda Boulevard to Hawthorne Boulevard; then north on Hawthorne Boulevard to Manhattan Beach Boulevard; then west on Manhattan Beach Boulevard to the

[2] *See* footnote 1.

Manhattan Beach Pier (coast of the Pacific Ocean); then north and west along the coast of the Pacific Ocean to a point directly south of the intersection of Pacific Coast Highway (State Highway 1) and Malibu Canyon/Las Virgenes Road (County Highway N1); then north from that point to and on Malibu Canyon/Las Virgenes Road to Mulholland Drive; then west on Mulholland Drive to Kanan Road; then north on Kanan Road to U.S. Highway 101; then west on U.S. Highway 101 to the Los Angeles/Ventura County line; then northeast, east, north, east, and north along the Los Angeles/Ventura County line to State Highway 126; then northeast to the point where the Los Angeles/Kern County line is intersected by an imaginary line drawn between the intersection of the Los Angeles/Ventura County line and State Highway 126 and the intersection of Tehachapi Willow Springs Road and West 100th Street (the latter intersection is in the city of Mojave); then east along the Los Angeles/Kern County line to the Los Angeles/San Bernardino County line; then south along the Los Angeles/San Bernardino County line to the Los Angeles/Orange County line; then west, south, and southwest along the Los Angeles/Orange County line to the point of beginning.

Orange County. That portion of the county that lies north of a line drawn as follows: Beginning at the intersection of the Orange/Riverside County line and State Highway 91; then west on State Highway 91 to State Highway 90 (Imperial Highway); then northwest on State Highway 90 to State Highway 39 (Beach Boulevard); then south on State Highway 39 to Katella Avenue; then west on Katella Avenue to the Los Angeles/Orange County line.

Riverside County. That portion of the county bounded by a line drawn as follows: Beginning at the intersection of the San Bernardino County line and the eastern city limit of Cherry Valley; then south along the eastern city limit of Cherry Valley to Highland Springs Avenue; then south on Highland Springs Avenue to Interstate Highway 10; then west on Interstate Highway 10 to State Highway 79 (Lambs Canyon Road); then south on State Highway 79 to State Highway 74; then west on State Highway 74 to State Street in the city of Hemet; then south on State Street to Diamond Valley Road; then west on Diamond Valley Road to Palm Avenue; then south on Palm Avenue to De Portola Road; then south on De Portola Road to East Benton Road; then southeast from that point along an imaginary line to the intersection of Sage Road and State Highway 79; then east on State Highway 79 to State Highway 371; then southeast to the point where the Riverside/San Diego County line is intersected by an imaginary line drawn between the intersection of State Highway 79 and State Highway 371 and the intersection of State Highway 78 and West Side Road (the latter intersection is in San Diego County); then west along the Riverside/San Diego County line to the point where that line turns from northeast to due west; then northwest from that point along an imaginary line to the Riverside/Orange County line at the point where it turns from northeast to northwest (west of the city of Lake Elsinore); then northwest from that point along the Riverside/Orange County line to the Riverside/San Bernardino County line; then north and east along the Riverside/San Bernardino County line to the point of beginning.

San Bernardino County. That portion of the county that lies south and west of a line drawn as follows: Beginning at the Kern/San Bernardino County line at the southeastern corner of Kern County; then southeast from that point along an imaginary line to the intersection of Stoddard Wells Road and Dale Evans Parkway in the town of Apple Valley; then south on Dale Evans Parkway to Waalew Road; then east on Waalew Road to the Apple Valley town limit; then southeast from that point along an imaginary line to the intersection of State Highway 247 and Northside Road; then east on Northside Road to Meridian Road; then south on Meridian Road to Cambria Road; then east on Cambria Road to Post Office Road; then south on Post Office Road to State Highway 18; then southwest from that point along an imaginary line to the intersection of State Highway 18 and State Highway 38 (North Shore Drive) located west of the city of Big Bear Lake; then south from that point along an imaginary line to the San Bernardino/Riverside County line at the point where that county line turns from west to south just northwest of the city of Banning.

Ventura County. That portion of the county bounded by a line drawn as follows: Beginning at the intersection of the Ventura/Los Angeles County line and U.S. Highway 101; then west on U.S. Highway 101 to State Highway 34 (North Lewis Road); then north on State Highway 34 to State Highway 118; then northeast along an imaginary line to the intersection of Old Telegraph Road and State Highway 126; then east on State Highway 126 to the Ventura/Los Angeles County line; then south along the Ventura/Los Angeles County line to the point of beginning.

Done in Washington, DC, this 30th day of July 2003.

Peter Fernandez,

Acting Administrator, Animal and Plant Health Inspection Service.

[FR Doc. 03–19695 Filed 8–1–03; 8:45 am]

BILLING CODE 3410–34–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1

[TD 9083]

RIN 1545–AH49

Golden Parachute Payments

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to golden parachute payments under section 280G of the Internal Revenue Code. These regulations incorporate changes and clarifications to reflect comments received concerning the proposed regulations primarily concerning the small corporation exemption, prepayment of the excise tax, and the definition of change in ownership or control.

DATES: *Effective Date:* August 4, 2003. These regulations apply to any payment that is contingent on a change in ownership or control if the change in ownership or control occurs on or after January 1, 2004.

Comments on the collection of information in § 1.280G–1, Q/A–7(a), should be received by October 3, 2003.

ADDRESSES: Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, W:CAR:MP:T:T:SP, Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Erinn Madden at (202) 622–6030 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information in this final rule has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget (OMB) under 44 U.S.C. 3507 and assigned control number 1545–1851.

The collection of information in this regulation is in § 1.280G–1, Q/A–7(a). This information is a brief description of all material facts concerning all payments which would be parachute payments (but for § 1.280G–1, Q/A–6). This information may be used by certain corporations with no readily tradeable stock (assuming certain shareholder approval requirements are also met) to determine if the payments to a disqualified individual are exempt from the definition of parachute payments. The collection of information is voluntary. The likely respondents are business or other for-profit institutions.

Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by October 3, 2003. Comments are specifically requested concerning:

Whether the collection[s] of information is necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the collection of information (*see* below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of service to provide information.

Estimated total annual reporting and/or recordkeeping burden: 12,000 hours.

Estimated average annual burden hours per respondent: 15 hours.

Estimated number of respondents and/or recordkeepers: 800

Estimated annual frequency of responses: On occasion.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains amendments to 26 CFR part 1 under section 280G of the Internal Revenue Code (Code). Sections 280G and 4999 of the Code were added to the Code by section 67 of the Deficit Reduction Act of 1984, Public Law 98–369 (98 Stat. 585). Section 280G was amended by section 1804(j) of the Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2807), section 1018(d) of the Technical and Miscellaneous Revenue Act of 1988, Public Law 100–647 (102 Stat. 3581) and section 1421 of the Small Business Job Protection Act of 1996, Public Law 104–188 (110 Stat. 1755).

Section 280G denies a deduction to a corporation for any excess parachute payment. Section 4999 imposes a 20-percent excise tax on the recipient of any excess parachute payment. Related provisions include section 275(a)(6), which denies the recipient a deduction for the section 4999 excise tax, and section 3121(v)(2)(A), which relates to the Federal Insurance Contributions Act.

On February 20, 2002, a notice of proposed rulemaking (REG–209114–90, 2002–2 I.R.B. 576), was published in the **Federal Register** at 67 FR 7630 (the 2002 proposed regulations) and corrected in the **Federal Register** at 67 FR 42210 on June 21, 2002. No hearing was requested or held. The IRS received written and electronic comments responding to the notice of proposed rulemaking. After consideration of the comments, the 2002 proposed regulations are adopted as amended by this Treasury decision. The significant revisions are discussed below.

Explanation of Provisions and Summary of Comments

Overview

Section 280G(b)(2)(A) defines a *parachute payment* as any payment that meets all of the following four conditions: (a) The payment is in the nature of compensation; (b) the payment is to, or for the benefit of, a disqualified individual; (c) the payment is contingent on a change in the ownership of a corporation, the effective control of a corporation, or the ownership of a substantial portion of the assets of a corporation (a change in ownership or control); and (d) the payment has (together with other payments described in (a), (b), and (c) of this paragraph with respect to the same individual) an aggregate present value of at least 3 times the individual's base amount. Section 280G(b)(2)(B) provides that the term *parachute payment* also includes any payment in the nature of compensation to, or for the benefit of, a disqualified individual if the payment is pursuant to an agreement that violates any generally enforced securities laws or regulations (securities violation parachute payment).

Section 280G(b)(1) defines the term *excess parachute payment* as an amount equal to the excess of any parachute payment over the portion of the disqualified individual's base amount that is allocated to such payment. For this purpose, the portion of the base amount allocated to a parachute payment is the amount that bears the same ratio to the base amount as the present value of the parachute payment bears to the aggregate present value of all such payments to the same disqualified individual.

Generally, excess parachute payments may be reduced by certain amounts of reasonable compensation. Section 280G(b)(4)(B) provides that, except in the case of securities violation parachute payments, the amount of an excess parachute payment is reduced by any portion of the payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered by the disqualified individual before the date of the change in ownership or control. Such reasonable compensation is first offset against the portion of the base amount allocated to the payment.

Exempt Payments

Section 280G specifically exempts from the definition of the term *parachute payment* several types of payments that would otherwise constitute parachute payments. Deductions for payments exempt from the definition of *parachute payment* are not disallowed by section 280G, and such exempt payments are not subject to the 20-percent excise tax of section 4999. In addition, such exempt payments are not taken into account in applying the 3-times-base-amount test of section 280G(b)(2)(A)(ii).

1. Tax-Exempt Entities

Q/A–6 of the 2002 proposed regulations provides that a payment with respect to a tax-exempt entity that would otherwise constitute a parachute payment is exempt from the definition of the term *parachute payment* if certain conditions are satisfied. First, the payment must be made by a corporation undergoing a change in ownership or control that is a *tax-exempt organization.* As defined in the 2002 proposed regulations, a *tax-exempt organization* is any organization described in section 501(c) that is subject to any express statutory prohibition against inurement of net earnings to the benefit of any private shareholder or individual, an organization described in sections 501(c)(1) or 501(c)(21), any religious or apostolic organization described in section 501(d), or any qualified tuition program described in section 529. Second, the organization must meet the definition of *tax-exempt organization*, as defined in the 2002 proposed regulations, both immediately before and immediately after the change in ownership or control.

One commentator requested the elimination of the requirement that the payment must be made by a tax-exempt organization. Instead, the commentator suggested that the regulations require only that the payment be approved by the tax-exempt organization. The exemption included in Q/A–6 of the 2002 proposed regulations for certain tax-exempt entities described in section 501(c) is premised on the fact that those entities are subject to a statutory prohibition on private inurement. Requiring merely the approval of a tax-exempt organization would allow corporations not subject to the inurement prohibition to make the payments and, thus, to avoid the application of section 280G. Thus, these regulations retain the requirements contained in the 2002 proposed regulations.

2. Small Corporation Exemption

Under section 280G and the 2002 proposed regulations, the term *parachute payment* does not include any payment to a disqualified individual with respect to a corporation which (immediately before the change in ownership or control) was a small business corporation (as defined in section 1361(b) but without regard to section 1361(b)(1)(C) thereof). *See also*, Q/A–6(a)(1).

Commentators indicated that the 2002 proposed regulations do not clearly address whether a corporation that does not elect to be treated as an S Corporation, but could make the election (because aside from the election the corporation otherwise meets the requirements to be treated as an S corporation), may use the exemption under Q/A–6(a)(1). These regulations clarify that a corporation that could elect to be treated as an S Corporation under the Code, but does not do so, may nevertheless use the exemption of Q/A–6(a)(1) for any payments to a disqualified individual.

In addition, commentators recommended that the final regulations provide that a corporation domiciled outside the United States can qualify for both the small business corporation exception and the shareholder approval exception. With respect to the small business corporation exception, Treasury and the IRS do not have the authority to expand this exception to include foreign corporations. Section 280G(b)(5)(A)(i) refers to ''a small business corporation (as defined in section 1361(b) but without regard to paragraph (1)(C) thereof).'' A small business corporation as defined in section 1361(b) must be a domestic corporation, and section 1361(b)(1)(C) merely addresses the existence of a nonresident alien as a shareholder. It is clear from the statute that the small business corporation exception cannot apply to a foreign corporation.

On the other hand, Treasury and the IRS believe that a foreign corporation may qualify for the shareholder approval exception, discussed below, if all of the applicable requirements are satisfied. Because the statute and regulations permit this result, it is not necessary to specify the treatment in the final regulations.

3. Shareholder Approval

Additionally, under section 280G and the 2002 proposed regulations, the term *parachute payment* does not include any payment to a disqualified individual with respect to a corporation if (i) immediately before the change in ownership or control, no stock in such corporation was readily tradeable on an established securities market or otherwise, and (ii) certain shareholder approval requirements are met.

Section 280G(b)(5)(B) provides that the shareholder approval requirements are met if two conditions are satisfied. First, the payment is approved by a vote of the persons who owned, immediately before the change in ownership or control, more than 75 percent of the voting power of all outstanding stock of the corporation. Second, there is adequate disclosure to shareholders of all material facts concerning all payments which (but for this rule) would be parachute payments with respect to a disqualified individual.

Q/A–7(b) of the 2002 proposed regulations provides rules to determine the shareholders who are entitled to vote. In response to comments, Q/A–7(b)(1) is revised to clarify that only stock that would otherwise be entitled to vote is considered outstanding and is entitled to vote for purposes of Q/A–7(b). Thus, for example, because an individual who only holds options generally would not be entitled to vote, such individual will not be considered to hold outstanding stock entitled to vote for purposes of Q/A–7.

Q/A–7(b)(2) of the 2002 proposed regulations includes a rule of administrative convenience allowing the corporation to identify shareholders eligible to vote for this purpose using the shareholders of record at the time of any vote taken in connection with a transaction or event giving rise to the change in ownership or control within the three-month period ending on the date of the change in ownership or control.

Several commentators suggested that the final regulations permit corporations to determine the shareholders of record at any time during the three months prior to the change in ownership or control. Other commentators requested that the time be expanded in the final regulations. In response to these comments, these regulations expand this rule to allow corporations to determine the shareholders of record on any day during the six-month period ending on the date of the change in ownership or control, regardless of whether there was a vote on that day.

Q/A–7(b)(4) is revised to clarify that stock held (directly or indirectly) by a disqualified individual who would receive a parachute payment if the shareholder approval requirements of Q/A–7 are not met is not entitled to vote with respect to a payment to be made to any disqualified individual. For example, assume E is a disqualified individual with respect to Corporation X. E's base amount is $100,000, and on a change in ownership or control of X, E will receive contingent payments of $295,000. Corporation X undergoes a change in ownership or control. In determining the persons who are entitled to vote under Q/A–7(b), any stock held by E is considered outstanding and E is entitled to vote. If E would receive contingent payments of $305,000 on the change in ownership or control, any stock held by E is not considered outstanding and is not entitled to vote under Q/A–7 with respect to payments to any disqualified individual.

An entity shareholder is not entitled to vote stock that it holds that is constructively owned by a disqualified person who would receive a parachute payment if the shareholder approval requirements of Q/A–7 are not met. Additionally, these regulations provide in Q/A–7(b)(4) that if the person authorized to vote the stock of an entity shareholder is a disqualified individual who would receive a parachute payment if the requirements of Q/A–7 are not met, such person is not permitted to vote any of the shares held by the entity shareholder. However, the entity shareholder is permitted to authorize another equity interest holder in the entity shareholder to vote the otherwise eligible shares or, in the case of a trust, another person eligible to vote on behalf of the trust. Thus, for example, assume a partner owns one-third of a partnership; the partner is authorized to vote on behalf of the partnership; the partnership owns stock in a corporation; the partner is a disqualified individual with respect to the corporation; and the corporation undergoes a change in ownership or control. Under these circumstances, none of the stock held by the partnership is entitled to vote under Q/A–7. However, the partnership is permitted to appoint an equity interest holder in the entity shareholder (who is not a disqualified individual who would receive parachute payments if the shareholder approval requirements of Q/A–7 are not met) to vote two-thirds of the stock.

More generally, several commentators requested significant revisions to Q/A–7 to reflect certain business practices. The revisions suggested by commentators include, among other things, treating approval of a compensation agreement when the agreement is executed as sufficient for Q/A–7 or deeming shareholders who acquire stock after approval of any compensation agreements to consent to any parachute payments contained in these agreements. While the Treasury Department and IRS understand that the requirements of Q/A–7 may not coincide with certain business practices, the requirements of Q/A–7 are based on the statutory framework provided by Congress. The golden parachute provisions are intended to protect equity shareholders whose interest in the corporation could be impaired by parachute payments to disqualified individuals by discouraging these types of payments. The basic structure of section 280G does not permit any approval or shareholder vote for a publicly traded corporation. The exception for corporations that are not publicly traded is based on a vote of those persons who hold shares immediately before the change in ownership or control after adequate disclosure. The suggested revisions to the shareholder approval requirements are inconsistent with these requirements and, accordingly, no changes are made in these regulations.

Payment of the Excise Tax Under Section 4999

Q/A–11(c) of the 2002 proposed regulations provided a mechanism to allow a disqualified individual to prepay the excise tax under section 4999 in certain circumstances. Thus, the requirements of section 4999 may be satisfied in the year of the change in ownership or control (or the first year for which a payment contingent on a change in ownership or control is certain to be made) even though the payment is not yet includible in income (or otherwise received).

These regulations continue to allow the prepayment of the excise tax in the year of the change in ownership or control. These regulations also provide that a taxpayer may prepay the excise tax in a later year. For purposes of prepayment, these regulations require the payor and disqualified individual to treat the payment of the excise tax consistently and require the payor to satisfy its obligations under section 4999. These regulations clarify that the prepayment of the excise tax is based on the present value of the excise tax that would be due in the year the excess parachute payment would actually be paid. For purposes of determining the present value of the excise tax due, the discount rate is determined in accordance with Q/A–32.

Thus, for example, assume that E is a disqualified individual with respect to Corporation X, that X undergoes a change in ownership or control, and that E receives parachute payments, including a series of annual payments to be made for the next 10 years. Assume further that all other parachute payments to E are made in the year of the change in ownership or control (with payment of the excise tax and compliance by X with section 4999(c)). Under these regulations, if three years after a change in ownership or control, X and E agree that E will prepay the excise tax related to the remaining annual payments, and that X will satisfy its obligations under section 4999(c) related to these payments, E is permitted to prepay the excise tax with respect to the remaining payments.

The 2002 proposed regulations provided that the prepayment of the excise tax would not be available with respect to certain payments, including payments related to health benefits or coverage. Commenters requested that the prepayment option be expanded to include health benefits or coverage. Treasury and the IRS do not consider the available valuation methods sufficient to allow projections of individual payments related to health coverage or health benefits for this purpose. In the event that valuation methods change or there is otherwise greater certainty with respect to the valuation of such benefits, Treasury and the IRS may consider additional guidance that would make prepayment of the excise tax with respect to such benefits available.

Treatment of Options

Q/A–13 of the 2002 proposed regulations provides that the transfer of an option is treated as a payment when the option becomes substantially vested without regard to whether the option has an ascertainable fair market value under § 1.83–7(b) of the regulations. Thus, the vesting of an option is treated as a payment in the nature of compensation for purposes of section 280G. Vested is defined in these regulations as substantially vested within the meaning of § 1.83–3(b) and (j) or the right to the payment is not otherwise subject to a substantial risk of forfeiture within the meaning of section 83(c).

The 2002 proposed regulations, and the 1989 proposed regulations, provided that options must be valued under the facts and circumstances of a particular case. Factors relevant to the determination include, but are not limited to: The difference between the option's exercise price and the value of the option property, the probability of the value of the option property increasing or decreasing, and the length of the period during which the option can be exercised.

In coordination with the issuance of the 2002 proposed regulations, the Commissioner issued two revenue procedures under section 280G providing additional guidance on the valuation of options, Rev. Proc. 2002–13, 2002–8 I.R.B. 549, and Rev. Proc. 2002–45, 2002–27 I.R.B. 40. These revenue procedures provide guidance on the use of option valuation methods, and provide that using only the spread between the exercise price and the value of the option property is not an adequate method for valuing an option. The revenue procedures also provide a safe harbor method of valuation based on a table. Comments received in response to these revenue procedures raised issues related to the difficulty of valuing options in the context of a change in ownership or control, particularly with respect to assumptions regarding the term of the option and the volatility. In coordination with the issuance of these regulations, the IRS is issuing a revenue procedure restating the previous revenue procedures and addressing these comments.

Disqualified Individuals

The 2002 proposed regulations provide that an individual is a disqualified individual if, at any time during the disqualified individual determination period, the individual is an employee or independent contractor of the corporation and is, with respect to the corporation, a shareholder (*see* Q/A–17), an officer (*see* Q/A–18), or (3) a highly-compensated individual (*see* Q/A–19). The 2002 proposed regulations provide that whether an individual is an officer with respect to a corporation is determined based on all the facts and circumstances in the particular case (such as the source of the individual's authority, the term for which the individual is elected or appointed, and the nature and extent of the individual's duties).

These regulations retain this rule concerning officers. However, under Q/A–18 of these regulations any individual who has the title of officer is presumed to be an officer unless the facts and circumstances demonstrate that the individual does not have the authority of an officer. However, an individual who does not have the title of officer may nevertheless be considered an officer if the facts and circumstances demonstrate that the individual should be considered to be an officer.

Nonvested Payments Under Q/A–24

Under Q/A–24(c) of the 2002 proposed regulations, only a portion of certain nonvested payments is treated as contingent on a change in ownership or control. Specifically, Q/A–24(c) applies to a payment that becomes vested as a result of a change in ownership or control to the extent that (i) without regard to the change in ownership or control, the payment was contingent only on the continued performance of services for the corporation for a specified period of time; and (ii) the payment is attributable, at least in part, to the performance of services before the date the payment is made or becomes certain to be made.

These regulations retain these rules regarding the calculation of the amount of the payment that is considered contingent on a change in ownership or control, with one revision. Under the 2002 proposed regulations, the payment calculation under Q/A–24(c) could not exceed the amount of the accelerated payment. A portion of a payment is contingent on a change in ownership or control if there is accelerated vesting, even if there is no accelerated payment. In that case, the amount attributable to the lapse of the obligation to perform services is 1 percent of the present value of the future payment multiplied by the number of full months between the date that the individual's right to receive the payment is vested and the date that, absent the acceleration, the payment would have been vested. Under these final regulations, the total portion of such payment treated as contingent on the change in ownership or control cannot exceed the present value of the accelerated payment.

Change in Ownership or Control

A change in ownership or control is defined in Q/A–27, 28, and 29 of the 2002 proposed regulations. Under Q/A–27 of the 2002 proposed regulations, a change in control of a corporation occurs on the date that any one person (or persons acting as a group) acquires ownership or stock of the corporation that, together with stock held by such person or group, has more than 50 percent of the total fair market value or total voting power of the corporation.

Under Q/A–28 of the 2002 proposed regulations, a change in the effective control of a corporation is presumed to occur on the date that either (1) any one person (or more than one person acting as a group) acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) ownership of stock of the corporation possessing 20 percent or more of the total voting power of the stock of such corporation, or (2) a majority of members of the corporation's board of directors is replaced during any 12-month period by directors whose appointment or election is not endorsed by a majority of the members of the corporation's board of directors prior to the date of the appointment or election.

Under Q/A–29 of the 2002 proposed regulations, a change in the ownership of a substantial portion of a corporation's assets occurs on the date that any one person (or more than one person acting as a group) acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person) assets from the corporation that have a total gross fair market value equal to or more than one third of the total gross fair market value of all of the assets of the corporation immediately prior to such acquisition.

These regulations generally follow the same approach as the 2002 proposed regulations. Some commenters suggested that these three provisions explicitly address whether more than one change in ownership or control can occur in a single transaction. In response to these comments, these regulations explicitly adopt the ''one change'' rule that historically has been applied by the IRS. These regulations provide that if a corporation undergoes a change in ownership or control as described in either Q/A–27 or Q/A–29, the other corporation involved in the transaction does not undergo a change in ownership or control.[1] As these regulations apply, in any transaction involving two corporations, if one has a change in ownership or control under Q/A–27 or 29, the other corporation does not also have a change in ownership or control, under either Q/A–27 or 29. Under these regulations, Q/A–28, which relates to effective control, provides that there is no change in effective control of a corporation in a transaction in which the other corporation has a change of control under Q/A–27 or 29.

Commentators also requested that the final regulations define gross fair market value for purposes of Q/A–29. Under Q/A–29 of these regulations, *gross fair market value* is defined as the value of the assets of the corporation, or the value of the assets being disposed of, determined without regard to any liabilities associated with such assets. This definition is used throughout these regulations.

For purposes of determining whether there is a change in ownership or control under Q/A–27 through Q/A–29 of the 2002 proposed regulations, two or more persons may be considered as acting as a group. The 2002 proposed regulations provide that, for purposes of determining whether two or more persons are acting as a group, a person who owns stock in both corporations involved in a transaction (an overlapping shareholder) is treated as acting as a group with respect to the other shareholders in a corporation only to the extent of such person's ownership of stock in that corporation prior to the transaction, and not with respect to his or her ownership in the other corporation. This rule is consistent with the interpretation of the 1989 proposed regulations by the IRS.

Commentators suggested different alternatives to the overlapping shareholder rule of Q/A–27 through Q/A–29 of the 2002 proposed regulations. One commentator suggested eliminating the overlapping shareholder rule and instead relying on the presumption of Q/A–28 for all transactions. Under this approach it would be possible for a transaction to result in one, two, or no

[1] Because Q/A–46 provides that all members of an affiliated group are treated as one corporation, even transactions involving multiple entities generally are treated as only two corporations for purposes of section 280G.

change in ownership or control. Other commentators suggested replacing the overlapping shareholder rule of the 2002 proposed regulations with a new rule based on section 355 or 382. Finally, another commentator requested clarification of the application of the overlapping shareholder rule of the 2002 proposed regulations under the 1989 proposed regulations.

These regulations retain the overlapping shareholder rule of the 2002 proposed regulations. The group concepts in section 355 or 382 do not fit well with the overall purpose of section 280G. Finally, these regulations are effective with respect to changes in ownership or control that occur after January 1, 2004, and to payments that are contingent on such changes. These regulations do not provide any transitional rules for the application of the overlapping shareholder rules for prior periods both because these regulations are not effective for prior periods and because the positions set forth in 2002 proposed regulations are merely clarifications of the positions taken by the IRS under section 280G (illustrated by the 1989 proposed regulations).

International Issues

Commentators recommended that the final regulations provide that a disqualified individual who, during the disqualified individual determination period, was a nonresident alien and was not subject to income tax in the United States on wages earned from the affiliated group, not be subject to the excise tax. Treasury and the IRS do not believe that they have the authority to preclude application of the excise tax to a nonresident alien under these circumstances. Accordingly, the final regulations do not include any special rules for excess parachute payments received by nonresident aliens.

Commentators also requested clarification that, even though parachute payments made by a foreign subsidiary of a U.S. corporation may not be deductible, such payments reduce the foreign subsidiary's earnings and profits. Because this issue has implications beyond section 280G and foreign subsidiaries, it is not addressed in these regulations.

Effective Date and Reliance

These regulations apply to any payments that are contingent on a change in ownership or control if the change of ownership or control occurs on or after January 1, 2004.

Under the 2002 proposed regulations, taxpayers are permitted to rely on the 2002 proposed regulations until the effective date of the final regulations. Taxpayers are permitted to rely on the 1989 proposed regulations with respect to payments contingent on a change in ownership or control if that change occurs before January 1, 2004. A clarification in the 2002 proposed regulations does not support reliance on the 1989 proposed regulations for a position contrary to the provisions of the 1989 proposed regulations.

Taxpayers are permitted to rely on the 2002 proposed regulations, including for purposes of amended returns with respect to the following: (1) That a shareholder who owns stock with a fair market value of $1 million is not a disqualified individual and (2) that the base amount includes the amount of compensation included in gross income under section 83(b).

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. Section 1.280G–1 of these proposed regulations provides for the collection of information. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that, as indicated in the Paperwork Reduction Act section earlier in the preamble, only 800 small entities are expected to be affected by the regulations annually, and it is unlikely that any small entity would be affected by these regulations more than once or twice in its existence. Therefore, an analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Erinn Madden, Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

■ Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1986

■ **Paragraph 1.** The authority citation for part 1 is amended by adding the following entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.280G–1 also issued under 26 U.S.C. 280G(b) and (e). * * *

■ **Par. 2.** Section § 1.280G–1 is added to read as follows:

§ 1.280G–1 Golden parachute payments.

The following questions and answers relate to the treatment of golden parachute payments under section 280G of the Internal Revenue Code of 1986, as added by section 67 of the Tax Reform Act of 1984 (Pub. L. No. 98–369; 98 Stat. 585) and amended by section 1804(j) of the Tax Reform Act of 1986 (Pub. L. No. 99–514; 100 Stat. 2807), section 1018(d)(6)–(8) of the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. No. 100–647; 102 Stat. 3581), and section 1421 of the Small Business Job Protection Act of 1996 (Pub. L. No. 104–188; 110 Stat. 1755). The following is a table of subjects covered in this section:

Overview

Q–1: What is the effect of Internal Revenue Code section 280G?

A–1: (a) Section 280G disallows a deduction for any excess parachute payment paid or accrued. For rules relating to the imposition of a nondeductible 20-percent excise tax on the recipient of any excess parachute payment, see Internal Revenue Code sections 4999, 275(a)(6), and 3121(v)(2)(A).

(b) The disallowance of a deduction under section 280G is not contingent on the imposition of the excise tax under section 4999. The imposition of the excise tax under section 4999 is not contingent on the disallowance of a deduction under section 280G. Thus, for example, because the imposition of the excise tax under section 4999 is not contingent on the disallowance of a deduction under section 280G, a payee may be subject to the 20-percent excise tax under section 4999 even though the disallowance of the deduction for the excess parachute payment may not directly affect the federal taxable income of the payor.

Q–2: What is a parachute payment for purposes of section 280G?

A–2: (a) The term *parachute payment* means any payment (other than an exempt payment described in Q/A–5) that—

(1) Is in the nature of compensation;

(2) Is made or is to be made to (or for the benefit of) a disqualified individual;

(3) Is contingent on a change—

(i) In the ownership of a corporation;

(ii) In the effective control of a corporation; or

(iii) In the ownership of a substantial portion of the assets of a corporation; and

(4) Has (together with other payments described in paragraphs (a)(1), (2), and (3) of this A–2 with respect to the same disqualified individual) an aggregate present value of at least 3 times the individual's base amount.

(b) Hereinafter, a change referred to in paragraph (a)(3) of this A–2 is generally referred to as a change in ownership or control. For a discussion of the application of paragraph (a)(1), *see* Q/A–11 through Q/A–14; paragraph (a)(2), Q/A–15 through Q/A–21; paragraph (a)(3), Q/A–22 through Q/A–29; and paragraph (a)(4), Q/A–30 through Q/A–36.

(c) The term *parachute payment* also includes any payment in the nature of compensation to (or for the benefit of) a disqualified individual that is pursuant to an agreement that violates a generally enforced securities law or regulation. This type of parachute payment is referred to in this section as a securities violation parachute payment. *See* Q/A–37 for the definition and treatment of securities violation parachute payments.

Q–3: What is an excess parachute payment for purposes of section 280G?

A–3: The term *excess parachute payment* means an amount equal to the excess of any parachute payment over the portion of the base amount allocated to such payment. Subject to certain exceptions and limitations, an excess parachute payment is reduced by any portion of the payment which the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered by the disqualified individual before the date of the change in ownership or control. For a discussion of the nonreduction of a securities violation parachute payment by reasonable compensation, *see* Q/A–37. For a discussion of the computation of excess parachute payments and their reduction by reasonable compensation, *see* Q/A–38 through Q/A–44.

Q–4: What is the effective date of section 280G and this section?

A–4: In general, section 280G applies to payments under agreements entered into or renewed after June 14, 1984. Section 280G also applies to certain payments under agreements entered into on or before June 14, 1984, and amended or supplemented in significant relevant respect after that date. This section applies to any payment that is contingent on a change in ownership or control and the change in ownership or control occurs on or after January 1, 2004. For a discussion of the application of the effective date, *see* Q/A–47 and Q/A–48.

Exempt Payments

Q–5: Are some types of payments exempt from the definition of the term *parachute payment*?

A–5: (a) Yes, the following five types of payments are exempt from the definition of *parachute payment*—

(1) Payments with respect to a small business corporation (described in Q/A–6 of this section);

(2) Certain payments with respect to a corporation no stock in which is readily tradeable on an established securities market (or otherwise) (described in Q/A–6 of this section);

(3) Payments to or from a qualified plan (described in Q/A–8 of this section);

(4) Certain payments made by a corporation undergoing a change in ownership or control that is described in any of the following sections of the Internal Revenue Code: section 501(c) (but only if such organization is subject to an express statutory prohibition against inurement of net earnings to the benefit of any private shareholder or individual, or if the organization is described in section 501(c)(1) or section 501(c)(21)), section 501(d), or section 529, collectively referred to as *tax-exempt organizations* (described in Q/A–6 of this section); and

(5) Certain payments of reasonable compensation for services to be rendered on or after the change in ownership or control (described in Q/A–9 of this section).

(b) Deductions for payments exempt from the definition of *parachute payment* are not disallowed by section 280G, and such exempt payments are not subject to the 20-percent excise tax of section 4999. In addition, such exempt payments are not taken into account in applying the 3-times-base-amount test of Q/A–30 of this section.

Q–6: Which payments with respect to a corporation referred to in paragraph (a)(1), (a)(2), or (a)(4) of Q/A–5 of this section are exempt from the definition of *parachute payment*?

A–6: (a) The term *parachute payment* does not include—

(1) Any payment to a disqualified individual with respect to a corporation which (immediately before the change in ownership or control) would qualify as a small business corporation (as defined in section 1361(b) but without regard to section 1361(b)(1)(C) thereof), without regard to whether the corporation had an election to be treated as a corporation under section 1361 in effect on the date of the change in ownership or control;

(2) Any payment to a disqualified individual with respect to a corporation (other than a small business corporation described in paragraph (a)(1) of this A–6) if—

(i) Immediately before the change in ownership or control, no stock in such corporation was readily tradeable on an established securities market or otherwise; and

(ii) The shareholder approval requirements described in Q/A–7 of this section are met with respect to such payment; or

(3) Any payment to a disqualified individual made by a corporation which is a tax-exempt organization (as defined in paragraph (a)(4) of Q/A–5 of this section), but only if the corporation meets the definition of a tax-exempt organization both immediately before and immediately after the change in ownership or control.

(b) For purposes of paragraph (a)(1) of this A–6, the members of an affiliated group are not treated as one corporation.

(c) The requirements of paragraph (a)(2)(i) of this A–6 are not met with respect to a corporation if a substantial portion of the assets of any entity consists (directly or indirectly) of stock in such corporation and any ownership interest in such entity is readily tradeable on an established securities market or otherwise. For this purpose, such stock constitutes a substantial portion of the assets of an entity if the total fair market value of the stock is equal to or exceeds one third of the total gross fair market value of all of the assets of the entity. For this purpose, *gross fair market value* means the value of the assets of the entity, determined without regard to any liabilities associated with such assets. If a corporation is a member of an affiliated group (which group is treated as one corporation under A–46 of this section), the requirements of paragraph (a)(2)(i) of this A–6 are not met if any stock in any member of such group is readily tradeable on an established securities market or otherwise.

(d) For purposes of paragraph (a)(2)(i) of this A–6, the term *stock* does not include stock described in section 1504(a)(4) if the payment does not adversely affect the redemption and liquidation rights of any shareholder owning such stock.

(e) For purposes of paragraph (a)(2)(i) of this A–6, stock is treated as readily tradeable if it is regularly quoted by brokers or dealers making a market in such stock.

(f) For purposes of paragraph (a)(2)(i) of this A–6, the term *established securities market* means an established securities market as defined in § 1.897–1(m).

(g) The following examples illustrate the application of this exemption:

Example 1. A small business corporation (within the meaning of paragraph (a)(1) of this A–6) operates two businesses. The corporation sells the assets of one of its businesses, and these assets represent a substantial portion of the assets of the corporation. Because of the sale, the corporation terminates its employment relationship with persons employed in the business the assets of which are sold. Several of these employees are highly-compensated individuals to whom the owners of the corporation make severance payments in excess of 3 times each employee's base amount. Since the corporation is a small business corporation immediately before the change in ownership or control, the payments are not parachute payments.

Example 2. Assume the same facts as in *Example 1*, except that the corporation is not a small business corporation within the meaning of paragraph (a)(1) of this A–6. If no stock in the corporation is readily tradeable on an established securities market (or otherwise) immediately before the change in ownership or control and the shareholder approval requirements described in Q/A–7 of this section are met, the payments are not parachute payments.

Example 3. Stock of Corporation S is owned by Corporation P, stock in which is readily tradeable on an established securities market. The Corporation S stock equals or exceeds one third of the total gross fair market value of the assets of Corporation P, and thus, represents a substantial portion of the assets of Corporation P. Corporation S makes severance payments to several of its highly-compensated individuals that are parachute payments under section 280G and Q/A–2 of this section. Because stock in Corporation P is readily tradeable on an established securities market, the payments are not exempt from the definition of *parachute payments* under this A–6.

Example 4. A is a corporation described in section 501(c)(3), and accordingly, its net earnings are prohibited from inuring to the benefit of any private shareholder or individual. A transfers substantially all of its assets to another corporation resulting in a change in ownership or control. Contingent on the change in ownership or control, A makes a payment that, but for the potential application of the exemption described in A–5(a)(4), would constitute a *parachute payment.* However, one or more aspects of the transaction that constitutes the change in ownership or control causes A to fail to be described in section 501(c)(3). Accordingly, A fails to meet the definition of a *tax-exempt organization* both immediately before and immediately after the change in ownership or control, as required by this A–6. As a result, the payment made by A that was contingent on the change in ownership or control is not exempt from the definition of parachute payment under this A–6.

Example 5. B is a corporation described in section 501(c)(15). B does not meet the definition of a *tax-exempt organization* because section 501(c)(15) does not expressly prohibit inurement of B's net earnings to the benefit of any private shareholder or individual. Accordingly, if B has a change in ownership or control and makes a payment that would otherwise meet the definition of a *parachute payment*, such payment is not exempt from the definition of the term *parachute payment* for purposes of this A–6.

Q–7: How are the shareholder approval requirements referred to in paragraph (a)(2)(ii) of Q/A–6 of this section met?

A–7: (a) *General rule.* The shareholder approval requirements referred to in paragraph (a)(2)(ii) of Q/A–6 of this section are met with respect to any payment if—

(1) Such payment is approved by more than 75 percent of the voting power of all outstanding stock of the corporation entitled to vote (as described in this A–7) immediately before the change in ownership or control; and

(2) Before the vote, there was adequate disclosure to all persons entitled to vote (as described in this A–7) of all material facts concerning all material payments which (but for Q/A–6 of this section) would be parachute payments with respect to a disqualified individual.

(b) *Voting requirements*—(1) *General rule.* The vote described in paragraph (a)(1) of this A–7 must determine the right of the disqualified individual to receive the payment, or, in the case of a payment made before the vote, the right of the disqualified individual to retain the payment. Except as otherwise provided in this A–7, the normal voting rules of the corporation are applicable. Thus, for example, an optionholder is generally not permitted to vote for purposes of this A–7. For purposes of this A–7, the vote can be on less than the full amount of the payment(s) to be made. Shareholder approval can be a single vote on all payments to any one disqualified individual, or on all payments to more than one disqualified individual. The total payment(s) submitted for shareholder approval, however, must be separately approved by the shareholders. The requirements of this paragraph (b)(1) are not satisfied if approval of the change in ownership or control is contingent, or otherwise conditioned, on the approval of any payment to a disqualified individual that would be a parachute payment but for Q/A–6 of this section.

(2) *Special rule.* A vote to approve the payment does not fail to be a vote of the outstanding stock of the corporation entitled to vote immediately before the change in ownership or control merely because the determination of the shareholders entitled to vote on the payment is based on the shareholders of record as of any day within the six-month period immediately prior to and ending on date of the change in ownership or control, provided the disclosure requirements described in paragraph (c) of this A–7 are met.

(3) *Entity shareholder.* (i) Approval of a payment by any shareholder that is not an individual (an entity shareholder) generally must be made by the person authorized by the entity shareholder to approve the payment. See paragraph (b)(4) of this A–7 if the person so authorized by the entity shareholder is a disqualified individual who would receive a parachute payment if the shareholder approval requirements of this A–7 are not met.

(ii) However, if a substantial portion of the assets of an entity shareholder consists (directly or indirectly) of stock in the corporation undergoing the change in ownership or control, approval of the payment by that entity shareholder must be made by a separate vote of the persons who hold, immediately before the change in ownership or control, more than 75 percent of the voting power of the entity shareholder entitled to vote. The preceding sentence does not apply if the value of the stock of the corporation owned, directly or indirectly, by or for the entity shareholder does not exceed 1 percent of the total value of the outstanding stock of the corporation undergoing a change in ownership or control. Where approval of a payment by an entity shareholder must be made by a separate vote of the owners of the entity shareholder, the normal voting rights of the entity shareholder determine which owners shall vote. For purposes of this (b)(3)(ii), stock represents a substantial portion of the assets of an entity shareholder if the total fair market value of the stock held by the entity shareholder in the corporation undergoing the change in ownership or control is equal to or exceeds one third of the total gross fair market value of all of the assets of the entity shareholder. For this purpose, *gross fair market value* means the value of the assets of the entity, determined without regard to any liabilities associated with such assets.

(4) *Disqualified individuals and attribution of stock ownership.* In determining the persons entitled to vote referred to in paragraph (a)(1) or (b)(3) of this A–7, stock that would otherwise be entitled to vote is not counted as outstanding stock and is not considered in determining whether the more than 75 percent vote has been obtained under this A–7 if the stock is actually owned or constructively owned under section 318(a) by or for a disqualified individual who receives (or is to receive) payments that would be parachute payments if the shareholder approval requirements described in paragraph (a) of this A–7 are not met. Likewise, stock is not counted as outstanding stock if the owner is considered under section 318(a) to own any part of the stock owned directly or indirectly by or for a disqualified individual described in the preceding sentence. In addition, if the person authorized to vote the stock of an entity shareholder is a disqualified individual who would receive a parachute payment if the shareholder approval requirements described in this A–7 are not met, such person is not permitted to vote such shares, but the entity shareholder is permitted to appoint an equity interest holder in the entity shareholder, or in the case of a trust another person eligible to vote on behalf of the trust, to vote the otherwise eligible shares. However, if all persons who hold voting power in the corporation undergoing the change in ownership or control are disqualified individuals or related persons described in this paragraph (b)(4), then such stock is counted as outstanding stock and votes by such persons are considered in determining whether the more than 75 percent vote has been obtained.

(c) *Adequate disclosure.* To be adequate disclosure for purposes of paragraph (a)(2) of this A–7, disclosure must be full and truthful disclosure of the material facts and such additional information as is necessary to make the disclosure not materially misleading at the time the disclosure is made. Disclosure of such information must be made to every shareholder of the corporation entitled to vote under this A–7. For each disqualified individual, material facts that must be disclosed include, but are not limited to, the event triggering the payment or payments, the total amount of the payments that would be parachute payments if the shareholder approval requirements described in paragraph (a) of this A–7 are not met, and a brief description of each payment (*e.g.*, accelerated vesting of options, bonus, or salary). An omitted fact is considered a material fact if there is a substantial likelihood that a reasonable shareholder would consider it important.

(d) *Corporation without shareholders.* If a corporation does not have shareholders, the exemption described in Q/A–6(a)(2) of this section and the shareholder approval requirements described in this A–7 do not apply. Solely for purposes of this paragraph (d), a shareholder does not include a member in an association, joint stock company, or insurance company.

(e) *Examples.* The following examples illustrate the application of this A–7:

Example 1. Corporation S has two shareholders—Corporation P, which owns 76 percent of the stock of Corporation S, and A, a disqualified individual who would receive a parachute payment if the shareholder approval requirements of this A–7 are not met. No stock of Corporation P or S is readily tradeable on an established securities market (or otherwise). The value of the stock of Corporation S equals or exceeds one third of the gross fair market value of the assets of Corporation P, and thus, represents a substantial portion of the assets of Corporation P. All of the stock of Corporation S is sold to Corporation M. Contingent on the change in ownership of Corporation S, severance payments are made to certain officers of Corporation S in excess of 3 times each officer's base amount. If the payments are approved by a separate vote of the persons who hold, immediately before the sale, more than 75 percent of the voting power of the outstanding stock entitled to vote of Corporation P and the disclosure rules of paragraph (a)(2) of this A–7 are complied with, the shareholder approval requirements of this A–7 are met, and the payments are exempt from the definition of *parachute payment* pursuant to A–6 of this section.

Example 2. (i) Stock of Corporation X, none of which is traded on an established market, is acquired by Corporation Y. In the voting ballot concerning the sale, the Corporation X shareholders are asked to vote either ''yes'' on the sale and ''yes'' to paying parachute payments to A, a disqualified individual with respect to Corporation A, or ''no'' on the sale and ''no'' to paying parachute payments to A.

(ii) Because the approval of the change in ownership or control is conditioned on the approval of the payments to A, the shareholder approval requirements of this A–7 are not satisfied. If the payments are made to A, the payments are not exempt from the definition of *parachute payment* pursuant to Q/A–6 of this section.

(iii) Assume the same facts as in paragraph (i) of this *Example 2,* except that the acquisition agreement between Corporation X and Corporation Y states that the acquisition is approved only if there are no parachute payments made to A. If the shareholder approval and the disclosure requirements described in this A–7 are met, the payments will not be parachute payments. Alternatively, if the shareholders do not approve the payments, the payments cannot be made (or retained). Thus, the transaction is not conditioned on the approval of the parachute payments. If the payments are made and the requirements of this A–7 are met, the payments are exempt from the definition of *parachute payment* pursuant to Q/A–6 of this section.

Example 3. Corporation M is wholly owned by Partnership P. No interest in either M or P is readily tradeable on an established securities market (or otherwise). The value of the stock of Corporation M equals or exceeds one third of the gross fair market value of the assets of Partnership P, and thus, represents a substantial portion of the assets of Partnership P. Corporation M undergoes a change in ownership or control. Partnership P has one general partner and 200 limited partners. The general partner is not a disqualified individual. None of the limited partners are entitled to vote on issues involving the management of the partnership investments. If the payments that would be parachute payments if the shareholder approval requirements of this A–7 are not met are approved by the general partner and the disclosure rules of paragraph (a)(2) of this A–7 are complied with, the shareholder approval requirements of this A–7 are met, and the payments are exempt from the definition of *parachute payment* pursuant to A–6 of this section.

Example 4. Corporation A has several shareholders including X and Y, who are disqualified individuals with respect to Corporation A and would receive parachute payments if the shareholder approval requirements of this A–7 are not met. No stock of Corporation A is readily tradeable on an established securities market (or otherwise). Corporation A undergoes a change in ownership or control. Contingent on the change in ownership or control, severance payments are payable to X and Y that are in excess of 3 times each individual's base amount. To determine whether the shareholder approval requirements of paragraph (a)(1) of this A–7 are satisfied regarding the payments to X and Y, the stock of X and Y is not considered outstanding, and X and Y are not entitled to vote.

Example 5. Assume the same facts as in *Example 4,* except that after adequate disclosure of all material facts (within the meaning of paragraph (a)(2) of this A–7) to all shareholders entitled to vote, 60 percent of the shareholders who are entitled to vote approve the payments to X and Y. Because more than 75 percent of the shareholders holding outstanding stock who were entitled to vote did not approve the payments to X and Y, the payments cannot be made.

Example 6. Assume the same facts as in *Example 4* except that disclosure of all the material facts (within the meaning of paragraph (a)(2) of this A–7) regarding the payments to X and Y is made to two of Corporation A's shareholders, who collectively own 80 percent of Corporation A's stock entitled to vote and approve the payment. Both shareholders approve the payments. Assume further that no adequate disclosure of the material facts regarding the payments to X and Y is made to other Corporation A shareholders who are entitled to vote within the meaning of this A–7. Notwithstanding that 80 percent of the shareholders entitled to vote approve the payments, because disclosure regarding the payments to X and Y is not made to all of Corporation A's shareholders who were entitled to vote, the disclosure requirements of paragraph (a)(2) of this A–7 are not met, and the payments are not exempt from the definition of *parachute payment* pursuant to Q/A–6.

Example 7. Corporation C has three shareholders—Partnership, which owns 20 percent of the stock of Corporation C; A, an individual who owns 60 percent of the stock of Corporation C; and B, an individual who owns 20 percent of Corporation C. Stock of Corporation C does not represent a substantial portion of the assets of Partnership. No interest in either Partnership or Corporation C is readily tradeable on an established securities market (or otherwise). P, a one-third partner in Partnership, is a disqualified individual with respect to Corporation C. Corporation C undergoes a change in ownership or control. Contingent on the change, a severance payment is payable to P in excess of 3 times P's base amount. To determine the persons who are entitled to vote referred to in paragraph (a)(1) of this A–7, one-third of the stock held by Partnership is not considered outstanding stock. If P is the person authorized by Partnership to approve the payment, none of the shares of Partnership are considered outstanding stock. However, Partnership is permitted to appoint an equity interest holder in Partnership (who is not a disqualified individual who would receive a parachute payment if the requirements of this A–7 are not met), to vote the two-thirds of the shares held by Partnership that are otherwise entitled to be voted.

Example 8. X, Y, and Z are all employees and disqualified individuals with respect to Corporation E. No stock in Corporation E is readily tradeable on an established securities market (or otherwise). Each individual has a base amount of $100,000. Corporation E undergoes a change in ownership or control. Contingent on the change, a severance payment of $400,000 is payable to X; $600,000 is payable to Y; and $1,000,000 is payable to Z. Corporation E provides each Corporation E shareholder entitled to vote (as determined under this A–7) with a ballot listing and describing the payments of $400,000 to X; $600,000 to Y; and $1,000,000 to Z and the triggering event that generated the payments. Next to each name and corresponding amount on the ballot, Corporation E requests approval (with a ''yes'' and ''no'' box) of each total payment to be made to each individual and states that if the payment is not approved the payment will not be made. Adequate disclosure, within the meaning of this A–7 is made to each shareholder entitled to vote under this A–7. More than 75 percent of the Corporation E shareholders who are entitled to vote under paragraph (a)(1) of this A–7 approve each payment to each individual. The shareholder approval requirements of this A–7 are met, and the payments are exempt from the definition of *parachute* payment pursuant to A–6 of this section.

Example 9. Assume the same facts as in Example 8 except that the ballot does not request approval of each total payment to each individual separately. Instead, the ballot states that $2,000,000 in payments will be made to X, Y, and Z and requests approval of the $2,000,000 payments. Assuming the triggering event and amount of the payments to X, Y, and Z are separately described to the shareholders entitled to vote under this A–7, the shareholder approval requirements of paragraph (a)(1) of this A–7 are met, and the payments are exempt from the definition of *parachute payment* pursuant to A–6 of this section.

Example 10. B, an employee of Corporation X, is a disqualified individual with respect to Corporation X. Stock of Corporation X is not readily tradeable on an established securities market (or otherwise). Corporation X undergoes a change in ownership or control. B's base amount is $205,000. Under B's employment agreement with Corporation X, in the event of a change in ownership or control, B's stock options will vest and B will receive severance and bonus payments. Contingent on the change in ownership or control, B's stock options with a fair market value of $500,000 immediately vest, $200,000 of which is contingent on the change, and B will receive a $200,000 bonus payment and a $400,000 severance payment. Corporation X distributes a ballot to every shareholder of Corporation X who immediately before the change is entitled to vote as described in this A–7. The ballot contains adequate disclosure of all material facts and lists the following payments to be made to B: The contingent payment of $200,000 attributable to options, a $200,000 bonus payment, and a $400,000 severance payment. The ballot requests shareholder approval of the $200,000 bonus payment to B and states that whether or not the $200,000 bonus payment is approved, B will receive $200,000 attributable to options and a $400,000 severance payment. More than 75 percent of the shareholders entitled to vote as described by this A–7 approve the $200,000 bonus payment to B. The shareholder approval requirements of this A–7 are met, and the $200,000 payment is exempt from the definition of *parachute payment* pursuant to A–6 of this section.

Q–8: Which payments under a qualified plan are exempt from the definition of *parachute payment*?

A–8: The term *parachute payment* does not include any payment to or from—

(a) A plan described in section 401(a) which includes a trust exempt from tax under section 501(a);

(b) An annuity plan described in section 403(a);

(c) A simplified employee pension (as defined in section 408(k)); or

(d) A simple retirement account (as defined in section 408(p)).

Q–9: Which payments of reasonable compensation are exempt from the definition of *parachute payment*?

A–9: Except in the case of securities violation *parachute payment*s, the term parachute payment does not include any payment (or portion thereof) which the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services to be rendered by the disqualified individual on or after the date of the change in ownership or control. See Q/A–37 of this section for the definition and treatment of securities violation parachute payments. See Q/A–40 through Q/A–44 of this section for rules on determining amounts of reasonable compensation.

Payor of Parachute Payments

Q–10: Who may be the payor of parachute payments?

A–10: Parachute payments within the meaning of Q/A–2 of this section may be paid, directly or indirectly, by—

(i) The corporation referred to in paragraph (a)(3) of Q/A–2 of this section;

(ii) A person acquiring ownership or effective control of that corporation or ownership of a substantial portion of that corporation's assets; or

(iii) Any person whose relationship to such corporation or other person is such as to require attribution of stock ownership between the parties under section 318(a).

Payments in the Nature of Compensation

Q–11: What types of payments are in the nature of compensation?

A–11: (a) *General rule.* For purposes of this section, all payments—in whatever form—are payments in the nature of compensation if they arise out of an employment relationship or are associated with the performance of services. For this purpose, the performance of services includes holding oneself out as available to perform services and refraining from performing services (such as under a covenant not to compete or similar arrangement). Payments in the nature of compensation include (but are not limited to) wages and salary, bonuses, severance pay, fringe benefits, life insurance, pension benefits, and other deferred compensation (including any amount characterized by the parties as interest thereon). A payment in the nature of compensation also includes cash when paid, the value of the right to receive cash, or a transfer of property. However, payments in the nature of compensation do not include attorney's fees or court costs paid or incurred in connection with the payment of any amount described in paragraphs (a)(1), (2), and (3) of Q/A–2 of this section or a reasonable rate of interest accrued on any amount during the period the parties contest whether a payment will be made.

(b) *When payment is considered to be made.* Except as otherwise provided in A–11 through Q/A–13 of this section, a payment in the nature of compensation is considered made (and is subject to the excise tax under section 4999) in the taxable year in which it is includible in the disqualified individual's gross income or, in the case of fringe benefits and other benefits excludible from income, in the taxable year the benefits are received.

(c) *Prepayment rule.* Notwithstanding the general rule described in paragraph (b) of this A–11, a disqualified individual may, in the year of the change in ownership or control, or any later year, prepay the excise tax under section 4999, provided that the payor and disqualified individual treat the payment of the excise tax consistently and the payor satisfies its obligations under section 4999(c) in the year of prepayment. The prepayment of the excise tax for purposes of section 4999 must be based on the present value of the excise tax that would be due in the year the excess parachute payment would actually be paid (calculated using the discount rate equal to 120 percent of the applicable Federal rate (determined under section 1274(d) and regulations thereunder; *see* Q/A–32)). For purposes of projecting the future value of a payment that provides for interest to be credited at a variable interest rate, it is permissible to make a reasonable assumption regarding this variable rate. A disqualified individual is not required to adjust the excise tax paid under this paragraph (c) merely because the interest rates in the future are not the same as the rate used for purposes of projecting the future value of the payment. However, a disqualified individual may not apply this paragraph (c) of this A–11 to a payment to be made in cash if the present value of the payment would be considered not reasonably ascertainable under section 3121(v) and § 31.3121(v)(2)–1(e)(4) of this Chapter or to a payment related to health benefits or coverage. The Commissioner may provide additional guidance regarding the applicability of this paragraph (c) to certain payments in published guidance of general applicability under § 601.601(d)(2) of this Chapter.

(d) *Transfers of property.* Transfers of property are treated as payments for purposes of this A–11. See Q/A–12 of this section for rules on determining when such payments are considered made and the amount of such payments. *See* Q/A–13 of this section for special rules on transfers of stock options.

(e) The following example illustrates the principles of this A–11:

Example. D is a disqualified individual with respect to Corporation X. D has a base amount of $100,000 and is entitled to receive two parachute payments, one of $200,000 and the other of $400,000. A change in ownership or control of Corporation X occurs on May 1, 2005, and the $200,000 payment is made to D at the time of the change in ownership or control. The $400,000 payment is to be made on October 1, 2010. Corporation X and D agree that D will prepay the excise tax and X will satisfy its obligations under section 4999(c) with respect to the $400,000 payment. Using discount rate determined under Q/A–32, Corporation X and D determine that the present value of the $400,000 payment is $300,000 on the date of the change in ownership or control. The portions of the base amount allocated to these payments are $40,000 (($200,000/$500,000) × $100,000) and $60,000 (($300,000/$500,000 × $100,000), respectively. Thus, the amount of the first excess parachute payment is $160,000 ($200,000 − $40,000) and that of the second excess parachute payment is $340,000 ($400,000 − $60,000). The excise tax on the $400,000 payment is $68,000 ($340,000 × 20 percent). Assume the present value (calculated in accordance with paragraph (c) of this A–11) of $68,000 is $50,000. To prepay the excise tax due on the $400,000 payment, Corporation X must satisfy its obligations under section 4999 with respect to the $50,000, in addition to the $32,000 withholding required with respect to the $200,000 payment.

Q–12: If a property transfer to a disqualified individual is a payment in the nature of compensation, when is the payment considered made (or to be made), and how is the amount of the payment determined?

A–12: (a) Except as provided in this A–12 and Q/A–13 of this section, a transfer of property is considered a payment made (or to be made) in the taxable year in which the property transferred is includible in the gross income of the disqualified individual under section 83 and the regulations thereunder. Thus, in general, such a payment is considered made (or to be made) when the property is transferred (as defined in § 1.83–3(a)) to the disqualified individual and becomes substantially vested (as defined in § 1.83–3(b) and (j)) in such individual. The amount of the payment is determined under section 83 and the regulations thereunder. Thus, in general, the amount of the payment is equal to the excess of the fair market value of the transferred property (determined without regard to any lapse restriction, as defined in § 1.83–3(i)) at the time that the property becomes substantially vested, over the amount (if any) paid for the property.

(b) An election made by a disqualified individual under section 83(b) with respect to transferred property will not apply for purposes of this A–12. Thus, even if such an election is made with respect to a property transfer that is a payment in the nature of compensation, for purposes of this section, the payment is generally considered made (or to be made) when the property is transferred to and becomes substantially vested in such individual.

(c) *See* Q/A–13 of this section for rules on applying this A–12 to transfers of stock options.

(d) The following example illustrates the principles of this A–12:

Example. On January 1, 2006, Corporation M gives to A, a disqualified individual, a bonus of 100 shares of Corporation M stock in connection with the performance of services to Corporation M. Under the terms of the bonus arrangement A is obligated to return the Corporation M stock to Corporation M unless the earnings of Corporation M double by January 1, 2009, or there is a change in ownership or control of Corporation M before that date. A's rights in the stock are treated as substantially nonvested (within the meaning of § 1.83–3(b)) during that period because A's rights in the stock are subject to a substantial risk of forfeiture (within the meaning of § 1.83–3(c)) and are nontransferable (within the meaning of § 1.83–3(d)). On January 1, 2008, a change in ownership or control of Corporation M occurs. On that day, the fair market value of the Corporation M stock is $250 per share. Because A's rights in the Corporation M stock become substantially vested (within the meaning of § 1.83–3(b)) on that day, the payment is considered made on that day, and the amount of the payment for purposes of this section is equal to $25,000 (100 × $250). *See* Q/A–38 through 41 for rules relating to the reduction of the excess parachute payment by the portion of the payment which is established to be reasonable compensation for personal services actually rendered before the date of a change in ownership or control.

Q–13: How are transfers of statutory and nonstatutory stock options treated?

A–13: (a) For purposes of this section, an option (including an option to which section 421 applies) is treated as property that is transferred when the option becomes vested (regardless of whether the option has a readily ascertainable fair market value as defined in § 1.83–7(b)). For purposes of this A–13, *vested* means substantially vested within the meaning of § 1.83–3(b) and (j) or the right to the payment is not otherwise subject to a substantial risk of forfeiture within the meaning of section 83(c). Thus, for purposes of this section, the vesting of such an option is treated as a payment in the nature of compensation. The value of an option at the time the option vests is determined under all the facts and circumstances in the particular case. Factors relevant to such a determination include, but are not limited to: The difference between the option's exercise price and the value of the property subject to the option at the time of vesting; the probability of the value of such property increasing or decreasing; and the length of the period during which the option can be exercised. Thus, an option is treated as a payment in the nature of compensation on the date of grant or vesting, as applicable, without regard to whether such option has an ascertainable fair market value. For purposes of this A–13, valuation may be determined by any method prescribed by the Commissioner in published guidance of general applicability under § 601.601(d)(2) of this Chapter.

(b) Any money or other property transferred to the disqualified individual on the exercise, or as consideration on the sale or other disposition, of an option described in paragraph (a) of this A–13 after the time such option vests is not treated as a payment in the nature of compensation to the disqualified individual under Q/A–11 of this section. Nonetheless, the amount of the otherwise allowable deduction under section 162 or 212 with respect to such transfer is reduced by the amount of the payment described in paragraph (a) of this A–13 treated as an excess parachute payment.

Q–14: Are payments in the nature of compensation reduced by consideration paid by the disqualified individual?

A–14: Yes, to the extent not otherwise taken into account under Q/A–12 and Q/A–13 of this section, the amount of any payment in the nature of compensation is reduced by the amount of any money or the fair market value of any property (owned by the disqualified individual without restriction) that is (or will be) transferred by the disqualified individual in exchange for the payment. For purposes of the preceding sentence, the fair market value of property is determined as of the date the property is transferred by the disqualified individual.

Disqualified Individuals

Q–15: Who is a disqualified individual?

A–15: (a) For purposes of this section, an individual is a disqualified individual with respect to a corporation if, at any time during the *disqualified individual determination period* (as defined in Q/A–20 of this section), the individual is an employee or independent contractor of the corporation and is, with respect to the corporation —

(1) A shareholder (but *see* Q/A–17 of this section);

(2) An officer (*see* Q/A–18 of this section); or

(3) A highly-compensated individual (*see* Q/A–19 of this section).

(b) For purposes of this A–15, a director is a disqualified individual with respect to a corporation if, at any time during the *disqualified individual determination period*, the director is, with respect to the corporation, a shareholder (*see* Q/A–17 of this section), an officer (*see* Q/A–18 of this section), or a highly-compensated individual (*see* Q/A–19 of this section).

(c) For purposes of this A–15, an individual who is an employee or independent contractor of a corporation other than the corporation undergoing a change in ownership or control is disregarded for purposes of determining who is a disqualified individual if such individual is employed by the corporation undergoing the change in ownership or control only on the last day of the disqualified individual determination period. Thus, for example, assume that E is an employee of Corporation X, that Y is acquired by Corporation X, and that Y undergoes a change in ownership or control. If E becomes an employee of Y on the date of the acquisition, in determining the disqualified individuals with respect to Y, E is disregarded under this paragraph (c).

Q–16: Is a personal service corporation treated as an individual?

A–16: (a) Yes. For purposes of this section, a personal service corporation (as defined in section 269A(b)(1)), or a noncorporate entity that would be a personal service corporation if it were a corporation, is treated as an individual.

(b) The following example illustrates the principles of this A–16:

Example. Corporation N, a personal service corporation (as defined in section 269A(b)(1)), has a single individual as its sole shareholder and employee. Corporation N performs personal services for Corporation M. The compensation paid to Corporation N by Corporation M puts Corporation N within the group of highly-compensated individuals of Corporation M as determined under A–19 of this section. Thus, Corporation N is treated as a highly-compensated individual with respect to Corporation M.

Q–17: Are all shareholders of a corporation considered shareholders for purposes of paragraphs (a)(1) and (b) of Q/A–15 of this section?

A–17: (a) No. Only an individual who owns stock of a corporation with a fair market value that exceeds 1 percent of the fair market value of the outstanding shares of all classes of the corporation's stock is treated as a disqualified individual with respect to the corporation by reason of stock ownership. An individual who owns a lesser amount of stock may, however, be a disqualified individual with respect to the corporation if such individual is an officer (*see* Q/A–18) or highly-compensated individual (see Q/A–19) with respect to the corporation.

(b) For purposes of determining the amount of stock owned by an individual for purposes of paragraph (a) of this A–17, the constructive ownership rules of section 318(a) apply. Stock underlying a vested option is considered owned by an individual who holds the vested option (and the stock underlying an unvested option is not considered owned by an individual who holds the unvested option). For purposes of the preceding sentence, however, if the option is exercisable for stock that is not substantially vested (as defined by §§ 1.83–3(b) and (j)), the stock underlying the option is not treated as owned by the individual who holds the option. Solely for purposes of determining the amount of stock owned by an individual for purposes of this A–17, mutual and cooperative corporations are treated as having stock.

(c) The following examples illustrates the principles of this A–17:

Example 1. E, an employee of Corporation A, received options under Corporation A's Stock Option Plan. E's stock options vest three years after the date of grant. E is not an officer or highly compensated individual during the disqualified individual determination period. E does not own, and is not considered to own under section 318, any other Corporation A stock. Two years after the options are granted to E, all of Corporation A's stock is acquired by Corporation B. Under Corporation A's Stock Option Plan, E's options are converted to Corporation B options and the vesting schedule remains the same. Under paragraph (b) of this A–17, the stock underlying the unvested options held by E on the date of the change in ownership or control is not considered owned by E. Because E is not considered to own Corporation A stock with a fair market value exceeding 1 percent of the total fair market value of all of the outstanding shares of all classes of Corporation A and E is not an officer or highly-compensated individual during the disqualified individual determination period, E is not a disqualified individual within the meaning of Q&A–15 of this section with respect to Corporation A.

Example 2. Assume the same facts as in *Example* 1, except that Corporation A's Stock Option Plan provides that all unvested options will vest immediately on a change in ownership or control. Under paragraph (b) of this A–17, the stock underlying the options that vest on the change in ownership or control is considered owned by E. If the stock considered owned by E exceeds 1 percent of the total fair market value of all of the outstanding shares of all classes of Corporation A stock (including for this purpose, all stock owned or constructively owned by all shareholders, provided that no share of stock is counted more than once), E is a disqualified individual within the meaning of Q/A–15 of this section with respect to Corporation A.

Example 3. Assume the same facts as in *Example 1* except that E received nonstatutory stock options that are exercisable for stock subject to a substantial risk of forfeiture under section 83. Assume further that under Corporation A's Stock Option Plan, the nonstatutory options will vest on a change in ownership or control. Under paragraph (b) of this A–17, E is not considered to own the stock underlying the options that vest on the change in ownership or control because the options are exercisable for stock subject to a substantial risk of forfeiture within the meaning of section 83. Because E is not considered to own Corporation A stock with a fair market value exceeding 1 percent of the total fair market value of all of the outstanding shares of all classes of Corporation A stock and E is not an officer or highly compensated individual during the disqualified individual determination period, E is not a disqualified individual within the meaning of Q/A–15 of this section with respect to Corporation A.

Q–18: Who is an officer?

A–18: (a) For purposes of this section, whether an individual is an officer with respect to a corporation is determined on the basis of all the facts and circumstances in the particular case (such as the source of the individual's authority, the term for which the individual is elected or appointed, and the nature and extent of the individual's duties). Any individual who has the title of officer is presumed to be an officer unless the facts and circumstances demonstrate that the individual does not have the authority of an officer. However, an individual who does not have the title of officer may nevertheless be considered an officer if the facts and circumstances demonstrate that the individual has the authority of an officer. Generally, the term officer means an administrative executive who is in regular and continued service. The term officer implies continuity of service and excludes those employed for a special and single transaction.

(b) An individual who is an officer with respect to any member of an affiliated group that is treated as one corporation pursuant to Q/A–46 of this section is treated as an officer of such one corporation.

(c) No more than 50 employees (or, if less, the greater of 3 employees, or 10 percent of the employees (rounded up to the nearest integer)) of the corporation (in the case of an affiliated group treated as one corporation, each member of the affiliated group) are treated as disqualified individuals with respect to a corporation by reason of being an officer of the corporation. For purposes of the preceding sentence, the number of employees of the corporation is the greatest number of employees the corporation has during the disqualified individual determination period (as defined in Q/A–20 of this section). If the number of officers of the corporation exceeds the number of employees who may be treated as officers under the first sentence of this paragraph (c), then the employees who are treated as officers for purposes of this section are the highest paid 50 employees (or, if less, the greater of 3 employees, or 10 percent of the employees (rounded up to the nearest integer)) of the corporation when ranked on the basis of compensation (as determined under Q/A–21 of this section) paid during the disqualified individual determination period.

(d) In determining the total number of employees of a corporation for purposes of this A–18, employees are not counted if they normally work less than 17½ hours per week (as defined in section 414(q)(5)(B) and the regulations thereunder) or if they normally work during not more than 6 months during any year (as defined in section 414(q)(5)(C) and the regulations thereunder). However, an employee who is not counted for purposes of the preceding sentence may still be an officer.

Q–19: Who is a highly-compensated individual?

A–19: (a) For purposes of this section, a highly-compensated individual with respect to a corporation is any individual who is, or would be if the individual were an employee, a member of the group consisting of the lesser of the highest paid 1 percent of the employees of the corporation (rounded up to the nearest integer), or the highest paid 250 employees of the corporation, when ranked on the basis of compensation (as determined under Q/A–21 of this section) earned during the disqualified individual determination period (as defined in Q/A–20 of this section). For purposes of the preceding sentence, the number of employees of the corporation is the greatest number of employees the corporation has during the disqualified individual determination period (as defined in Q/A–20 of this section). However, no individual whose annualized compensation during the disqualified individual determination period is less than the amount described in section 414(q)(1)(B)(i) for the year in which the change in ownership or control occurs will be treated as a highly-compensated individual.

(b) An individual who is not an employee of the corporation is not treated as a highly-compensated individual with respect to the corporation on account of compensation received for performing services (such as brokerage, legal, or investment banking services) in connection with a change in ownership or control of the corporation, if the services are performed in the ordinary course of the individual's trade or business and the individual performs similar services for a significant number of clients unrelated to the corporation.

(c) The total number of employees of a corporation for purposes of this A–19 is determined in accordance with Q/A–18(d) of this section. However, an employee who is not counted for purposes of the preceding sentence may still be a highly-compensated individual.

Q–20: What is the disqualified individual determination period?

A–20: The disqualified individual determination period is the twelve-month period prior to and ending on the date of the change in ownership or control of the corporation.

Q–21: How is *compensation* defined for purposes of determining who is a disqualified individual?

A–21: (a) For purposes of determining who is a disqualified individual, the term *compensation* means the compensation which was earned by the individual for services performed for the corporation with respect to which the change in ownership or control occurs (changed corporation), for a predecessor entity, or for a related entity. Such compensation is determined without regard to sections 125, 132(f)(4), 402(e)(3), and 402(h)(1)(B). Thus, for example, compensation includes elective or salary reduction contributions to a cafeteria plan, cash or deferred arrangement or tax-sheltered annuity, and amounts credited under a nonqualified deferred compensation plan.

(b) For purposes of this A–21, a predecessor entity is any entity which, as a result of a merger, consolidation, purchase or acquisition of property or stock, corporate separation, or other similar business transaction transfers some or all of its employees to the changed corporation or to a related entity or to a predecessor entity of the changed corporation. The term *related entity* includes—

(1) All members of a controlled group of corporations (as defined in section 414(b)) that includes the changed corporation or a predecessor entity;

(2) All trades or businesses (whether or not incorporated) that are under common control (as defined in section 414(c)) if such group includes the changed corporation or a predecessor entity;

(3) All members of an affiliated service group (as defined in section 414(m)) that includes the changed corporation or a predecessor entity; and

(4) Any other entities required to be aggregated with the changed corporation or a predecessor entity pursuant to section 414(o) and the regulations thereunder (except leasing organizations as defined in section 414(n)).

(c) For purposes of Q/A–18 and Q/A–19 of this section, compensation that was contingent on the change in ownership or control and that was payable in the year of the change is not treated as compensation.

Contingent on Change in Ownership or Control

Q–22: When is a payment contingent on a change in ownership or control?

A–22: (a) In general, a payment is treated as contingent on a change in ownership or control if the payment would not, in fact, have been made had no change in ownership or control occurred, even if the payment is also conditioned on the occurrence of another event. A payment generally is treated as one which would not, in fact, have been made in the absence of a change in ownership or control unless it is substantially certain, at the time of the change, that the payment would have been made whether or not the change occurred. (But *see* Q/A–23 of this section regarding payments under agreements entered into after a change in ownership or control.) A payment that becomes vested as a result of a change in ownership or control is not treated as a payment which was substantially certain to have been made whether or not the change occurred. For purposes of this A–22, *vested* means the payment is substantially vested within the meaning of § 1.83–3(b) and (j) or the right to the payment is not otherwise subject to a substantial risk of forfeiture as defined by section 83(c).

(b)(1) For purposes of paragraph (a), a payment is treated as contingent on a change in ownership or control if—

(i) The payment is contingent on an event that is closely associated with a change in ownership or control;

(ii) A change in ownership or control actually occurs; and

(iii) The event is materially related to the change in ownership or control.

(2) For purposes of paragraph (b)(1)(i) of this A–22, a payment is treated as contingent on an event that is closely associated with a change in ownership or control unless it is substantially certain, at the time of the event, that the payment would have been made whether or not the event occurred. An event is considered closely associated with a change in ownership or control if the event is of a type often preliminary or subsequent to, or otherwise closely associated with, a change in ownership or control. For example, the following events are considered closely associated with a change in the ownership or control of a corporation: The onset of a tender offer with respect to the corporation; a substantial increase in the market price of the corporation's stock that occurs within a short period (but only if such increase occurs prior to a change in ownership or control); the cessation of the listing of the corporation's stock on an established securities market; the acquisition of more than 5 percent of the corporation's stock by a person (or more than one person acting as a group) not in control of the corporation; the voluntary or involuntary termination of the disqualified individual's employment; a significant reduction in the disqualified individual's job responsibilities; and a change in ownership or control as defined in the disqualified individual's employment agreement (or elsewhere) that does not meet the definition of a change in ownership or control described in Q/A–27, 28, or 29 of this section. Whether other events are treated as closely associated with a change in ownership or control is based on all the facts and circumstances of the particular case.

(3) For purposes of determining whether an event (as described in paragraph (b)(2) of this A–22) is materially related to a change in ownership or control, the event is presumed to be materially related to a change in ownership or control if such event occurs within the period beginning one year before and ending one year after the date of the change in ownership or control. If such event occurs outside of the period beginning one year before and ending one year after the date of change in ownership or

control, the event is presumed not materially related to the change in ownership or control. A payment does not fail to be contingent on a change in ownership or control merely because it is also contingent on the occurrence of a second event (without regard to whether the second event is closely associated with or materially related to a change in ownership or control). Similarly, a payment that is treated as contingent on a change in ownership or control because it is contingent on a closely associated event does not fail to be treated as contingent on a change in ownership or control merely because it is also contingent on the occurrence of a second event (without regard to whether the second event is closely associated with or materially related to a change in ownership or control).

(c) A payment that would in fact have been made had no change in ownership or control occurred is treated as contingent on a change in ownership or control if the change in ownership or control (or the occurrence of an event that is closely associated with and materially related to a change in ownership or control within the meaning of paragraph (b)(1) of this A–22), accelerates the time at which the payment is made. Thus, for example, if a change in ownership or control accelerates the time of payment of deferred compensation that is vested without regard to the change in ownership or control, the payment may be treated as contingent on the change. *See* Q/A–24 of this section regarding the portion of a payment that is so treated. *See also* Q/A–8 of this section regarding the exemption for certain payments under qualified plans and Q/A–40 of this section regarding the treatment of a payment as reasonable compensation.

(d) A payment is treated as contingent on a change in ownership or control even if the employment or independent contractor relationship of the disqualified individual is not terminated (voluntarily or involuntarily) as a result of the change.

(e) The following examples illustrate the principles of this A–22:

Example 1. A corporation grants a stock appreciation right to a disqualified individual, A, more than one year before a change in ownership or control. After the stock appreciation right vests and becomes exercisable, a change in ownership or control of the corporation occurs, and A exercises the right. Assuming neither the granting nor the vesting of the stock appreciation right is contingent on a change in ownership or control, the payment made on exercise is not contingent on the change in ownership or control.

Example 2. A contract between a corporation and B, a disqualified individual, provides that a payment will be made to B if the corporation undergoes a change in ownership or control and B's employment with the corporation is terminated at any time over the succeeding 5 years. Eighteen months later, a change in the ownership of the corporation occurs. Two years after the change in ownership, B's employment is terminated and the payment is made to B. Because it was not substantially certain that the corporation would have made the payment to B on B's termination of employment if there had not been a change in ownership, the payment is treated as contingent on the change in ownership under paragraph (a) of this A–22. This is true even though B's termination of employment is presumed not to be, and in fact may not be, materially related to the change in ownership or control.

Example 3. A contract between a corporation and C, a disqualified individual, provides that a payment will be made to C if C's employment is terminated at any time over the succeeding 3 years (without regard to whether or not there is a change in ownership or control). Eighteen months after the contract is entered into, a change in the ownership or control of the corporation occurs. Six months after the change in ownership or control, C's employment is terminated and the payment is made to C. Termination of employment is considered an event closely associated with a change in ownership or control. Because the termination occurred within one year after the date of the change in ownership or control, the termination of C's employment is presumed to be materially related to the change in ownership or control under paragraph (b)(3) of this A–22. If this presumption is not successfully rebutted, the payment will be treated as contingent on the change in ownership or control under paragraph (b) of this A–22.

Example 4. A contract between a corporation and a disqualified individual, D, provides that a payment will be made to D upon the onset of a tender offer for shares of the corporation's stock. A tender offer is made on December 1, 2008, and the payment is made to D. Although the tender offer is unsuccessful, it leads to a negotiated merger with another entity on June 1, 2009, which results in a change in the ownership or control of the corporation. It was not substantially certain, at the time of the onset of the tender offer, that the payment would have been made had no tender offer taken place. The onset of a tender offer is considered closely associated with a change in ownership or control. Because the tender offer occurred within one year before the date of the change in ownership or control of the corporation, the onset of the tender offer is presumed to be materially related to the change in ownership or control. If this presumption is not rebutted, the payment will be treated as contingent on the change in ownership or control. If no change in ownership or control had occurred, the payment would not be treated as contingent on a change in ownership or control; however, the payment still could be a parachute payment under Q/A–37 of this section if the contract violated a generally enforced securities law or regulation.

Example 5. A contract between a corporation and a disqualified individual, E, provides that a payment will be made to E if the corporation's level of product sales or profits reaches a specified level. At the time the contract was entered into, the parties had no reason to believe that such an increase in the corporation's level of product sales or profits would be preliminary or subsequent to, or otherwise closely associated with, a change in ownership or control of the corporation. Eighteen months later, a change in the ownership or control of the corporation occurs and within one year after the date of the change of ownership or control, the corporation's level of product sales or profits reaches the specified level. Under these facts and circumstances (and in the absence of contradictory evidence), the increase in product sales or profits of the corporation is not an event closely associated with the change in ownership or control of the corporation. Accordingly, even if the increase is materially related to the change in ownership or control, the payment will not be treated as contingent on a change in ownership or control.

Q–23: May a payment be treated as contingent on a change in ownership or control if the payment is made under an agreement entered into after the change?

A–23: (a) No. Payments are not treated as contingent on a change in ownership or control if they are made (or are to be made) pursuant to an agreement entered into after the change (a post-change agreement). For this purpose, an agreement that is executed after a change in ownership or control pursuant to a legally enforceable agreement that was entered into before the change is considered to have been entered into before the change. (*See* Q/A–9 of this section regarding the exemption for reasonable compensation for services rendered on or after a change in ownership or control.) If an individual has a right to receive a payment that would be a parachute payment if made under an agreement entered into prior to a change in ownership or control (pre-change agreement) and gives up that right as bargained-for consideration for benefits under a post-change agreement, the agreement is treated as a post-change agreement only to the extent the value of the payments under the agreement exceed the value of the payments under the pre-change agreement. To the extent payments under the agreement have the same value as the payments under the pre-change agreement, such payments retain their character as parachute payments subject to this section.

(b) The following examples illustrate the principles of this A–23:

Example 1. Assume that a disqualified individual is an employee of a corporation. A change in ownership or control of the corporation occurs, and thereafter the individual enters into an employment agreement with the acquiring company. Because the agreement is entered into after the change in ownership or control occurs, payments to be made under the agreement are not treated as contingent on the change.

Example 2. Assume the same facts as in *Example 1,* except that the agreement between the disqualified individual and the acquiring company is executed after the change in ownership or control, pursuant to a legally enforceable agreement entered into before the change. Payments to be made under the agreement may be treated as contingent on the change in ownership or control pursuant to Q/A–22 of this section. However, see Q/A–9 of this section regarding the exemption from the definition of parachute payment for certain amounts of reasonable compensation.

Example 3. Assume the same facts as in *Example 1,* except that prior to the change in ownership or control, the individual and corporation enter into an agreement under which the individual will receive parachute payments in the event of a change in ownership or control of the corporation. After the change, the individual agrees to give up the right to payments under the pre-change agreement that would be parachute payments if made, in exchange for compensation under a new agreement with the acquiring corporation. Because the individual gave up the right to parachute payments under the pre-change agreement in exchange for other payments under the post-change agreement, payments in an amount equal to the parachute payments under the pre-change agreement are treated as contingent on the change in ownership or control under this A–23. Because the post-change agreement was entered into after the change, payments in excess of this amount are not treated as parachute payments.

Q–24: If a payment is treated as contingent on a change in ownership or control, is the full amount of the payment so treated?

A–24: (a)(1) *General rule.* Yes. If the payment is a transfer of property, the amount of the payment is determined under Q/A–12 or Q/A–13 of this section. For all other payments, the amount of the payment is determined under Q/A–11 of this section. However, in certain circumstances, described in paragraphs (b) and (c) of this A–24, only a portion of the payment is treated as contingent on the change. Paragraph (b) of this A–24 applies to a payment that is vested, without regard to the change in ownership or control, and is treated as contingent on the change in ownership or control because the change accelerates the time at which the payment is made. Paragraph (c) of this A–24 applies to a payment that becomes vested as a result of the change in ownership or control if, without regard to the change in ownership or control, the payment was contingent only on the continued performance of services for the corporation for a specified period of time and if the payment is attributable, at least in part, to services performed before the date the payment becomes vested. Paragraph (b) or (c) does not apply to any payment (or portion thereof) if the payment is treated as contingent on the change in ownership or control pursuant to Q/A–25 of this section. For purposes of this A–24, vested has the same meaning as provided in Q/A–22(a).

(2) *Reduction by reasonable compensation.* The amount of a payment under paragraph (a)(1) of this A–24 is reduced by any portion of such payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services rendered by the disqualified individual on or after the date of the change of control. *See* Q/A–9 and Q/A–38 through 44 of this section for rules concerning reasonable compensation. The portion of an amount treated as contingent under paragraph (b) or (c) of this A–24 may not be reduced by reasonable compensation.

(b) *Vested payments.* This paragraph (b) applies if a payment is vested, without regard to the change in ownership or control, and is treated as contingent on the change in ownership or control because the change accelerates the time at which the payment is made. In such a case, the portion of the payment, if any, that is treated as contingent on the change in ownership or control is the amount by which the amount of the accelerated payment exceeds the present value of the payment absent the acceleration. If the value of such a payment absent the acceleration is not reasonably ascertainable, and the acceleration of the payment does not significantly increase the present value of the payment absent the acceleration, the present value of the payment absent the acceleration is treated as equal to the amount of the accelerated payment. If the value of the payment absent the acceleration is not reasonably ascertainable, but the acceleration significantly increases the present value of the payment, the future value of such payment is treated as equal to the amount of the accelerated payment. For rules on determining present value, *see* paragraph (e) of this A–24, Q/A–32, and Q/A–33 of this section.

(c)(1) *Nonvested payments.* This paragraph (c) applies to a payment that becomes vested as a result of the change in ownership or control to the extent that—

(i) Without regard to the change in ownership or control, the payment was contingent only on the continued performance of services for the corporation for a specified period of time; and

(ii) The payment is attributable, at least in part, to the performance of services before the date the payment is made or becomes certain to be made.

(2) The portion of the payment subject to paragraph (c) of this A–24 that is treated as contingent on the change in ownership or control is the amount described in paragraph (b) of this A–24, plus an amount, as determined in paragraph (c)(4) of this A–24, to reflect the lapse of the obligation to continue to perform services. In no event can the portion of the payment treated as contingent on the change in ownership or control under this paragraph (c) exceed the amount of the accelerated payment, or, if the payment is not accelerated, the present value of the payment.

(3) For purposes of this paragraph (c) of this A–24, the acceleration of the vesting of a stock option or the lapse of a restriction on restricted stock is considered to significantly increase the value of a payment.

(4) The amount reflecting the lapse of the obligation to continue to perform services (described in paragraph (c)(2) of this A–24) is 1 percent of the amount of the accelerated payment multiplied by the number of full months between the date that the individual's right to receive the payment is vested and the date that, absent the acceleration, the payment would have been vested. This paragraph (c)(4) applies to the accelerated vesting of a payment in the nature of compensation even if the time at which the payment is made is not accelerated. In such a case, the amount reflecting the lapse of the obligation to continue to perform services is 1 percent of the present value of the future payment multiplied by the number of full months between the date that the individual's right to receive the payment is vested and the date that, absent the acceleration, the payment would have been vested.

(d) *Application of this A–24 to certain payments.*— (1) *Benefits under a nonqualified deferred compensation plan.* In the case of a payment of benefits under a nonqualified deferred compensation plan, paragraph (b) of this A–24 applies to the extent benefits under the plan are vested without regard to the change in ownership or control. Paragraph (c) of this A–24 applies to the extent benefits under the plan become vested as a result of the change in ownership or control and are attributable, at least in part, to the performance of services prior to vesting. Any other payment of benefits under a nonqualified deferred compensation plan is a payment in the nature of compensation subject to the general rule of paragraph (a) of this A–24 and the rules in Q/A–11 of this section.

(2) *Employment agreements.* The general rule of paragraph (a) of this A–24 (and not the rules in paragraphs (b) or (c)) applies to the payment of amounts due under an employment agreement on a termination of employment or a change in ownership or control that otherwise would be attributable to the performance of services (or refraining from the performance of services) during any period that begins after the date of termination of employment or change in ownership or control, as applicable. For purposes of this paragraph (d)(2) of this A–24, an employment agreement means an agreement between an employee or independent contractor and employer or service recipient which describes, among other things, the amount of compensation or remuneration payable to the employee or independent contractor. *See* Q/A–42(b) and 44 of this section for the treatment of the remaining amounts of salary under an employment agreement.

(3) *Vesting due to an event other than services.* Neither paragraph (b) nor (c) of this A–24 applies to a payment if (without regard to the change in ownership or control) vesting of the payment depends on an event other than the performance of services, such as the attainment of a performance goal, and the event does not occur prior to the change in ownership or control. In such circumstances, the full amount of the accelerated payment is treated as contingent on the change in ownership or control under paragraph (a) of this A–24. However, *see* Q/A–39 of this section for rules relating to the reduction of the excess parachute payment by the portion of the payment which is established to be reasonable compensation for personal services actually rendered before the date of a change in ownership or control.

(e) *Present value.* For purposes of this A–24, the present value of a payment is determined as of the date on which the accelerated payment is made.

(f) *Examples.* The following examples illustrate the principles of this A–24:

Example 1. (i) Corporation maintains a qualified plan and a nonqualified supplemental retirement plan (SERP) for its executives. Benefits under the SERP are not paid to participants until retirement. E, a disqualified individual with respect to Corporation, has a vested account balance of $500,000 under the SERP. A change in ownership or control of Corporation occurs. The SERP provides that in the event of a change in ownership or control, all vested accounts will be paid to SERP participants.

(ii) Because E was vested in $500,000 of benefits under the SERP prior to the change in ownership or control and the change merely accelerated the time at which the payment was made to E, only a portion of the payment, as determined under paragraph (b) of this A–24, is treated as contingent on the change. Thus, the portion of the payment that is treated as contingent on the change is the amount by which the amount of the accelerated payment ($500,000) exceeds the present value of the payment absent the acceleration.

(iii) Assume the same facts as in paragraph (i) of this *Example 1,* except that E's account balance of $500,000 is not vested. Instead, assume that E will vest in E's account balance of $500,000 in 2 years if E continues to perform services for the next 2 years. Assume further that the SERP provides that all unvested SERP benefits vest immediately on a change in ownership or control and are paid to the participants. Because the vesting of the SERP payment, without regard to the change, depends only on the performance of services for a specified period of time and the payment is attributable, in part, to the performance of services before the change in ownership or control, only a portion of the $500,000 payment, as determined under paragraph (c) of this A–24, is treated as contingent on the change. The portion of the payment that is treated as contingent on the change is the lesser of the amount of the accelerated payment or the amount by which the accelerated payment exceeds the present value of the payment absent the acceleration, plus an amount to reflect the lapse of the obligation to continue to perform services.

(iv) Assume the same facts as in paragraph (i) of this *Example 1,* except that in addition to the pay out of the vested account balance of $500,000 on the change in ownership or control, an additional $70,000 will be credited to E's account and included in the payment to E. Because the $500,000 was vested without regard to the change in ownership or control, paragraph (b) of this A–24 applies to the $500,000 payment. Because the $70,000 is not vested, without regard to the change, and is not attributable to the performance of services prior to the change, the entire $70,000 payment is contingent on the change in ownership or control under paragraph (a) of this A–24.

(v) Assume the same facts as in paragraph (i) of this *Example 1,* except that the benefit under the SERP is calculated using a percentage of final average compensation multiplied by years of service. If, contingent on the change in ownership or control, E is credited with additional years of service, an adjustment to final average compensation, or an increase in the applicable percentage, any increase in the benefit payable under the SERP is not attributable to the performance of services prior to the change, and the entire increase in the benefit is contingent on the change in ownership or control under paragraph (a) of this A–24.

Example 2. As a result of a change in the effective control of a corporation D, a disqualified individual with respect to the corporation, receives accelerated payment of D's vested account balance in a nonqualified deferred compensation account plan. Actual interest and other earnings on the plan assets are credited to each account as earned before distribution. Investment of the plan assets is not restricted in such a manner as would prevent the earning of a market rate of return on the plan assets. The date on which D would have received D's vested account balance absent the change in ownership or control is uncertain, and the rate of earnings on the plan assets is not fixed. Thus, the amount of the payment absent the acceleration is not reasonably ascertainable. Under these facts, acceleration of the payment does not significantly increase the present value of the payment absent the acceleration, and the present value of the payment absent the acceleration is treated as equal to the amount of the accelerated payment. Accordingly, no portion of the payment is treated as contingent on the change.

Example 3. (i) On January 15, 2006, a corporation and a disqualified individual, F, enter into a contract providing for a retention bonus of $500,000 to be paid to F on January 15, 2011. The payment of the bonus will be forfeited by F if F does not remain employed by the corporation for the entire 5-year period. However, the contract provides that the full amount of the payment will be made immediately on a change in ownership or control of the corporation during the 5-year period. On January 15, 2009, a change in ownership or control of the corporation occurs and the full amount of the payment ($500,000) is made on that date to F. Under these facts, the payment of $500,000 was contingent only on F's performance of services for a specified period and is attributable, in part, to the performance of services before the change in ownership or control. Therefore, only a portion of the payment, as determined under paragraph (c) of this A–24 is treated as contingent on the change. The portion of the payment that is treated as contingent on the change is the amount by which the amount of the accelerated payment (*i.e.*, $500,000, the amount paid to the individual because of the change in ownership) exceeds the present value of the payment that was expected to have been made absent the acceleration (*i.e.*, $406,838, the present value on January 15, 2009, of a $500,000 payment on January 15, 2011), plus $115,000 (1 percent × 23 months × $500,000) which is the amount reflecting the lapse of the obligation to continue to perform services. Accordingly, the amount of the payment treated as contingent on the change in ownership or control is $208,162, the sum of $93,162 ($500,000 − $406,838) + $115,000). This result does not change if F actually remains employed until the end of the 5-year period.

(ii) Assume the same facts as in paragraph (i) of this *Example 3,* except that the retention bonus will vest on the change in ownership or control, but will not be paid until January 15, 2011 (the original date in the contract). Because the payment of $500,000 was contingent only on F's performance of services for a specified period and is attributable, in part, to the performance of services before the change in ownership or control, only a portion of the $500,000 payment is treated as contingent on the change in ownership or control as determined under paragraph (c) of this A–24. Because there is accelerated vesting of the bonus, the portion of the payment treated as contingent on the change is the amount described in paragraph (b) of this A–27, which is $0 under these facts, plus an amount reflecting the lapse of the obligation to continue to perform services which is $93,573 (1 percent × 23 months × $406,838 (the present value of a $500,000 payment).

Example 4. (i) On January 15, 2006, a corporation gives to a disqualified individual, in connection with her performance of services to the corporation, a bonus of 1,000 shares of the corporation's stock. Under the terms of the bonus arrangement, the individual is obligated to return the stock to the corporation if she terminates her employment for any reason prior to January 15, 2011. However, if there is a change in the ownership or effective control of the corporation prior to January 15, 2011, she ceases to be obligated to return the stock. The individual's rights in the stock are treated as substantially nonvested (within the meaning of § 1.83–3(b) and (j)) during that period. On January 15, 2009, a change in the ownership of the corporation occurs. On that day, the fair market value of the stock is $500,000.

(ii) Under these facts, the payment was contingent only on performance of services for a specified period and is attributable, in part, to the performance of services before the change in ownership or control. Thus, only a portion of the payment, as determined under paragraph (c) of this A–24, is treated as contingent on the change in ownership or control. The portion of the payment that is treated as contingent on the change is the amount by which the present value of the accelerated payment on January 15, 2009 ($500,000), exceeds the present value of the payment that was expected to have been made on January 15, 2011, plus an amount reflecting the lapse of the obligation to continue to perform services. At the time of the change, it cannot be reasonably ascertained what the value of the stock would have been on January 15, 2011. The acceleration of the lapse of a restriction on stock is treated as significantly increasing the value of the payment. Therefore, the value of such stock on January 15, 2011, is deemed to be $500,000, the amount of the accelerated payment. The present value on January 15, 2009, of a $500,000 payment to be made on January 15, 2011, is $406,838. Thus, the portion of the payment treated as contingent on the change is $208,162, the sum of $93,162 ($500,000 − $406,838), plus $115,000 (1 percent × 23 months × $500,000), the amount reflecting the lapse of the obligation to continue to perform services.

Example 5. (i) On January 15, 2006, a corporation grants to a disqualified individual nonqualified stock options to purchase 30,000 shares of the corporation's stock. The options will be forfeited by the individual if he fails to perform personal services for the corporation until January 15, 2009. The options will, however, vest in the individual at an earlier date if there is a change in ownership or control of the corporation. On January 16, 2008, a change in the ownership or control of the corporation occurs and the options become vested in the individual. The value of the options on January 16, 2008, determined in accordance with Q/A–13, is $600,000.

(ii) The payment of the options to purchase 30,000 shares was contingent only on performance of services for the corporation until January 15, 2009, and is attributable, in part, to the performance of services before the change in ownership or control. Therefore, only a portion of the payment is treated as contingent on the change. The portion of the payment that is treated as contingent on the change is the amount by which the accelerated payment on January 16, 2008 ($600,000) exceeds the present value on January 16, 2008, of the payment that was expected to have been made on January 15, 2009, absent the acceleration, plus an amount reflecting the lapse of the obligation to continue to perform services. At the time of the change, it cannot be reasonably ascertained what the value of the options would have been on January 15, 2009. The acceleration of vesting in the options is treated as significantly increasing the value of the payment. Therefore, the value of such options on January 15, 2009, is deemed to be $600,000, the amount of the accelerated payment. The present value on January 16, 2008, of a $600,000 payment to be made on January 15, 2009, is $549,964. Thus, the portion of the payment treated as contingent on the change is $116,036, the sum of $50,036 ($600,000 − $549,964), plus an amount reflecting the lapse of the obligation to continue to perform services which is $66,000 (1 percent × 11 months × $600,000).

Example 6. (i) Assume the same facts as in *Example 5,* except that the options become vested periodically (absent a change in ownership or control), with one-third of the options vesting on January 15, 2007, 2008, and 2009, respectively. Thus, options to purchase 20,000 shares vest independently of the January 16, 2008, change in ownership or control and the options to purchase the remaining 10,000 shares vest as a result of the change in ownership or control.

(ii) The payment of the options to purchase 10,000 shares was contingent only on performance of services for the corporation until January 15, 2009, and is attributable, in part, to the performance of services before the change in ownership or control. Therefore, only a portion of the payment as determined under paragraph (c) of this A–24 is treated as contingent on the change in ownership or control. The portion of the payment that is treated as contingent on the change in ownership or control is the amount by which the accelerated payment on January 16, 2008 ($200,000) exceeds the present value on January 16, 2008, of the payment that was expected to have been made on January 15, 2009, absent the acceleration, plus an amount reflecting the lapse of the obligation to perform services. At the time of the change in ownership or control, it cannot be reasonably ascertained what the value of the options would have been on January 15, 2009. The acceleration of vesting in the options is treated as significantly increasing the value of the payment. Therefore, the value of such options on January 15, 2009, is deemed to be $200,000, the amount of the accelerated payment. The present value on January 16, 2008, of a $200,000 payment to be made on January 15, 2009, is $183,328.38. Thus, the portion of the payment treated as contingent on the change is $38,671.62, the sum of $16,671.62 ($200,000 − $183,328.38), plus an amount reflecting the lapse of the obligation to continue to perform services which is $22,000 (1 percent × 11 months × $200,000).

Example 7. Assume the same facts as in *Example 5,* except that the option agreement provides that the options will vest either on the corporation's level of profits reaching a specified level, or if earlier, on the date on which there is a change in ownership or control of the corporation. The corporation's level of profits do not reach the specified level prior to January 16, 2008. In such case, the full amount of the payment, $600,000, is treated as contingent on the change in ownership or control under paragraph (a) of this A–24. Because the payment was not contingent only on the performance of services for the corporation for a specified period, the rules of paragraph (b) and (c) of this A–24 do not apply. See Q/A–39 of this section for rules relating to the reduction of the excess parachute payment by the portion of the payment which is established to be reasonable compensation for personal services actually rendered before the date of a change in ownership or control.

Example 8. On January 1, 2005, E, a disqualified individual with respect to Corporation X, enters into an employment agreement with Corporation X under which E will be paid wages of $200,000 each year during the 5-year employment agreement. The employment agreement provides that if a change in ownership or control of Corporation X occurs, E will be paid the present value of the remaining salary under the employment agreement. On January 1, 2006, a change in ownership or control of Corporation X occurs, E is terminated, and E receives a payment of the present value of $200,000 for each of the 4 years remaining under the employment agreement. Because the payment represents future salary under an employment agreement (*i.e.,* amounts otherwise attributable to the performance of services for periods that begin after the termination of employment), the general rule of paragraph (a) of this A–24 applies to the payment and not the rules of paragraphs (b) and (c) of this A–24. See Q/A–42(c) and 44 of this section for the treatment of the remaining payments under an employment agreement.

Presumption That Payment Is Contingent on Change

Q–25: Is there a presumption that certain payments are contingent on a change in ownership or control?

A–25: Yes, for purposes of this section, any payment is presumed to be contingent on such a change unless the contrary is established by clear and convincing evidence if the payment is made pursuant to—

(a) An agreement entered into within one year before the date of a change in ownership or control; or

(b) An amendment that modifies a previous agreement in any significant respect, if the amendment is made within one year before the date of a change in ownership or control. In the case of an amendment described in paragraph (b) of this A–25, only the portion of any payment that exceeds the amount of such payment that would have been made in the absence of the amendment is presumed, by reason of the amendment, to be contingent on the change in ownership or control.

Q–26: How may the presumption described in Q/A–25 of this section be rebutted?

A–26: (a) To rebut the presumption described in Q/A–25 of this section, the taxpayer must establish by clear and convincing evidence that the payment is not contingent on the change in ownership or control. Whether the payment is contingent on such change is determined on the basis of all the facts and circumstances of the particular case. Factors relevant to such a determination include, but are not limited to, the content of the agreement or amendment and the circumstances surrounding the execution of the agreement or amendment, such as whether it was entered into at a time when a takeover attempt had commenced and the degree of likelihood that a change in ownership or control would actually occur. However, even if the presumption is rebutted with respect to an agreement, some or all of the payments under the agreement may still be contingent on the change in ownership or control pursuant to Q/A–22 of this section.

(b) In the case of an agreement described in Q/A–25 of this section, clear and convincing evidence that the agreement is one of the three following types will generally rebut the presumption that payments under the agreement are contingent on the change in ownership or control—

(1) A *nondiscriminatory employee plan or program as defined* in paragraph (c) of this A–26;

(2) A contract between a corporation and an individual that replaces a prior contract entered into by the same parties more than one year before the change in ownership or control, if the new contract does not provide for increased payments (apart from normal increases attributable to increased responsibilities or cost of living adjustments), accelerate the payment of amounts due at a future time, or modify (to the individual's benefit) the terms or conditions under which payments will be made; or

(3) A contract between a corporation and an individual who did not perform services for the corporation prior to the one year period before the change in ownership or control occurs, if the contract does not provide for payments that are significantly different in amount, timing, terms, or conditions from those provided under contracts entered into by the corporation (other than contracts that themselves were entered into within one year before the change in ownership or control and in contemplation of the change) with individuals performing comparable services.

(c) For purposes of this section, the term *nondiscriminatory employee plan or program* means: a group term life insurance plan that meets the requirements of section 79(d); a self insured medical reimbursement plan that meets the requirements of section 105(h); a cafeteria plan (within the meaning of section 125); an educational assistance program (within the meaning of section 127); a dependent care assistance program (within the meaning of section 129); a no-additional-cost service (within the meaning of section 132(b)) or qualified employee discount (within the meaning of section 132(c)); a qualified retirement planning services program under section 132(m); an adoption assistance program (within the meaning of section 137); and such other items as provided by the Commissioner in published guidance of general applicability under § 601.601(d)(2). Payments under certain other plans are exempt from the definition of *parachute payment* under Q/A–8 of this section.

(d) The following examples illustrate the application of the presumption:

Example 1. A corporation and a disqualified individual who is an employee of the corporation enter into an employment contract. The contract replaces a prior contract entered into by the same parties more than one year before the change in ownership or control and the new contract does not provide for any increased payments other than a cost of living adjustment, does not accelerate the payment of amounts due at a future time, and does not modify (to the individual's benefit) the terms or conditions under which payments will be made. Clear and convincing evidence of these facts rebuts the presumption described in A–25 of this section. However, payments under the contract still may be contingent on the change in ownership or control pursuant to Q/A–22 of this section.

Example 2. Assume the same facts as in *Example 1,* except that the contract is entered into after a tender offer for the corporation's stock had commenced and it was likely that a change in ownership or control would occur and the contract provides for a substantial bonus payment to the individual upon his signing the contract. The individual has performed services for the corporation for many years, but previous employment contracts between the corporation and the individual did not provide for a similar signing bonus. One month after the contract is entered into, a change in the ownership or control of the corporation occurs. All payments under the contract are presumed to be contingent on the change in ownership or control even though the bonus payment would have been legally required even if no change had occurred. Clear and convincing evidence of these facts rebuts the presumption described in A–25 of this section with respect to all of the payments under the contract with the exception of the bonus payment (which is treated as contingent on the change). However, payments other than the bonus under the contract still may be contingent on the change in ownership or control pursuant to Q/A–22 of this section.

Example 3. A corporation and a disqualified individual, who is an employee of the corporation, enter into an employment contract within one year of a change in ownership or control of the corporation. Under the contract, in the event of a change in ownership or control and subsequent termination of employment, certain payments will be made to the individual. A change in ownership or control occurs, but the individual is not terminated until 2 years after the change in ownership or control. If clear and convincing evidence does not rebut the presumption described in A–25 of this section, because the payment is made pursuant to an agreement entered into within one year of the date of the change in ownership or control, the payment is presumed contingent on the change under A–25 of this section. This is true even though A's termination of employment is presumed not to be materially related to the change in ownership or control under Q/A–22 of this section.

Change in Ownership or Control

Q–27: When does a change in the ownership of a corporation occur?

A–27: (a) For purposes of this section, a change in the ownership of a corporation occurs on the date that any one person, or more than one person acting as a group (as defined in paragraph (b) of this A–27), acquires ownership of stock of the corporation that, together with stock held by such person or group, has more than 50 percent of the total fair market value or total voting power of the stock of such corporation. However, if any one person, or more than one person acting as a group, is considered to own more than 50 percent of the total fair market value or total voting power of the stock of a corporation, the acquisition of additional stock by the same person or persons is not considered to cause a change in the ownership of the corporation (or to cause a change in the effective control of the corporation (within the meaning of Q/A–28 of this section)). An increase in the percentage of stock owned by any one person, or persons acting as a group, as a result of a transaction in which the corporation acquires its stock in exchange for property will be treated as an acquisition of stock for purposes of this section. This A–27 applies only when there is a transfer of stock of a corporation (or issuance of stock of a corporation) and stock in such corporation remains outstanding after the transaction. (*See* Q/A–29 for rules regarding the transfer of assets of a corporation).

(b) For purposes of paragraph (a) of this A–27, persons will not be considered to be acting as a group merely because they happen to purchase or own stock of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. If a person, including an entity shareholder, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only with respect to the ownership in that corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation.

(c) For purposes of this A–27 (and Q/A–28 and 29), section 318(a) applies to determine stock ownership. Stock underlying a vested option is considered owned by the individual who holds the vested option (and the stock underlying an unvested option is not considered owned by the individual who holds the unvested option). For purposes of the preceding sentence, however, if the option is exercisable for stock that is not substantially vested (as defined by sections 1.83–3(b) and (j)), the stock underlying the option is not treated as owned by the individual who holds the option. In addition, mutual and cooperative corporations are treated as having stock for purposes of this A–27.

(d) The following examples illustrate the principles of this A–27:

Example 1. Corporation M has owned stock with a fair market value equal to 19 percent of the value of the stock of Corporation N (an otherwise unrelated corporation) for many years prior to 2006. Corporation M acquires additional stock with a fair market value equal to 15 percent of the value of the stock of Corporation N on January 1, 2006, and an additional 18 percent on February 21, 2007. As of February 21, 2007, Corporation M has acquired stock with a fair market value greater than 50 percent of the value of the stock of Corporation N. Thus, a change in the ownership of Corporation N is considered to occur on February 21, 2007 (assuming that Corporation M did not have effective control of Corporation N immediately prior to the acquisition on that date).

Example 2. All of the corporation's stock is owned by the founders of the corporation. The board of directors of the corporation decides to offer shares of the corporation to the public. After the public offering, the founders of the corporation own a total of 40 percent of the corporation's stock, and members of the public own 60 percent. If no one person (or more than one person acting as a group) owns more than 50 percent of the corporation's stock (by value or voting power) after the public offering, there is no change in the ownership of the corporation.

Example 3. Corporation P merges into Corporation O (a previously unrelated corporation). In the merger, the shareholders of Corporation P receive Corporation O stock in exchange for their Corporation P stock. Immediately after the merger, the former shareholders of Corporation P own stock with a fair market value equal to 60 percent of the value of the stock of Corporation O, and the former shareholders of Corporation O own stock with a fair market value equal to 40 percent of the value of the stock of Corporation O. The former shareholders of Corporation P will be treated as acting as a group in their acquisition of Corporation O stock. Thus, a change in the ownership of Corporation O occurs on the date of the merger. See Q/A–29, *Example 3,* regarding whether there is a change in ownership or control of P.

Example 4. Assume the same facts as in *Example 3,* except that immediately after the change, the former shareholders of Corporation P own stock with a fair market value of 51 percent of the value of Corporation O stock and the former shareholders of Corporation O own stock with a fair market value equal to 49 percent of the value of Corporation O stock. Assume further that prior to the merger several Corporation O shareholders also owned Corporation P stock (overlapping shareholders). In the merger, those O shareholders received additional O stock by virtue of their ownership of P stock with a fair market value of 5 percent of the value of Corporation O stock. Including the O stock attributable to the P shares, the O shareholders hold 54 percent of O after the transaction. However, those overlapping shareholders that owned both Corporation O stock and Corporation P stock prior to the merger are treated as acting as a group with the Corporation O shareholders only with respect to their ownership interest in Corporation O prior to the transaction. Therefore, because the Corporation O shareholders owned 49 percent of the value of Corporation O stock, a change in the ownership of Corporation O occurs on the date of the merger. See Q/A–29, *Example 3,* regarding whether there is a change in ownership or control of P.

Example 5. A, an individual, owns stock with a fair market value equal to 20 percent of the value of the stock of Corporation Q. On January 1, 2007, Corporation Q acquires in a redemption for cash all of the stock held by shareholders other than A. Thus, A is left as the sole shareholder of Corporation O. A change in ownership of Corporation O is considered to occur on January 1, 2007 (assuming that A did not have effective control of Corporation Q immediately prior to the redemption).

Example 6. Assume the same facts as in *Example 5,* except that A owns stock with a fair market value equal to 51 percent of the value of all the stock of Corporation Q immediately prior to the redemption. There is no change in the ownership of Corporation Q as a result of the redemption.

Q–28: When does a change in the effective control of a corporation occur?

A–28: (a) Notwithstanding that a corporation has not undergone a change in ownership under Q/A–27, for purposes of this section, a change in the effective control of a corporation is presumed to occur on the date that either—

(1) Any one person, or more than one person acting as a group (as determined under paragraph (e) of this A–28), acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) ownership of stock of the corporation possessing 20 percent or more of the total voting power of the stock of such corporation; or

(2) A majority of members of the corporation's board of directors is replaced during any 12-month period by directors whose appointment or election is not endorsed by a majority of the members of the corporation's board of directors prior to the date of the appointment or election.

(b) The presumption of paragraph (a) of this A–28 may be rebutted by establishing that such acquisition or acquisitions of the corporation's stock, or such replacement of the majority of the members of the corporation's board of directors, does not transfer the power to control (directly or indirectly) the management and policies of the corporation from any one person (or more than one person acting as a group) to another person (or group). For purposes of this section, in the absence of an event described in paragraph (a)(1) or (2) of this A–28, a change in the effective control of a corporation is presumed not to have occurred.

(c) In no event does a change in effective control under this A–28 occur in any transaction in which either of the two corporations involved in the transaction has a change in ownership or control under Q/A–27 or 29 of this section. Thus, for example, assume Corporation P transfers more than one-third of the total gross fair market value of its assets to Corporation O in exchange for 20 percent of O's stock. Because P has undergone a change in ownership of a substantial portion of its assets under Q/A–29 of this section, O does not have a change in effective control under Q/A–28.

(d) If any one person, or more than one person acting as a group, is considered to effectively control a corporation (within the meaning of this A–28), the acquisition of additional control of the corporation by the same person or persons is not considered to cause a change in the effective control of the corporation (or to cause a change in the ownership of the corporation within the meaning of Q/A–27 of this section).

(e) For purposes of this A–28, persons will not be considered to be acting as a group merely because they happen to purchase or own stock of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. If a person, including an entity shareholder, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only with respect to the ownership in that corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation.

(f) For purposes of determining stock ownership, *see* Q/A–27(c).

(g) The following examples illustrate the principles of this A–28:

Example 1. Shareholder A acquired the following percentages of the voting stock of Corporation M (an otherwise unrelated corporation) on the following dates: 16 percent on January 1, 2005; 10 percent on January 10, 2006; 8 percent on February 10, 2006; 11 percent on March 1, 2007; and 8 percent on March 10, 2007. Thus, on March 10, 2007, A owns a total of 53 percent of M's voting stock. Because A did not acquire 20 percent or more of M's voting stock during any 12-month period, there is no presumption of a change in effective control pursuant to paragraph (a)(1) of this A–28. In addition, under these facts there is a presumption that no change in the effective control of Corporation M occurred. If this presumption is not rebutted (and thus no change in effective control of Corporation M is treated as occurring prior to March 10, 2007), a change in the ownership of Corporation M is treated as having occurred on March 10, 2007 (pursuant to Q/A–27 of this section) because A had acquired more than 50 percent of Corporation M's voting stock as of that date.

Example 2. A minority group of shareholders of a corporation opposes the practices and policies of the corporation's current board of directors. A proxy contest ensues. The minority group presents its own slate of candidates for the board at the next annual meeting of the corporation's shareholders, and candidates of the minority group are elected to replace a majority of the current members of the board. A change in the effective control of the corporation is presumed to have occurred on the date the election of the new board of directors becomes effective.

Q–29: When does a change in the ownership of a substantial portion of a corporation's assets occur?

A–29: (a) For purposes of this section, a change in the ownership of a substantial portion of a corporation's assets occurs on the date that any one person, or more than one person acting as a group (as determined in paragraph (c) of this A–29), acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) assets from the corporation that have a total gross fair market value equal to or more than one-third of the total gross fair market value of all of the assets of the corporation immediately prior to such acquisition or acquisitions. For this purpose, *gross fair market value* means the value of the assets of the corporation, or the value of the assets being disposed of, determined without regard to any liabilities associated with such assets. This A–29 applies in any situation other than one involving the transfer of stock (or issuance of stock) in a parent corporation and stock in such corporation remains outstanding after the transaction. Thus, this A–29 applies to the sale of stock in a subsidiary (when that subsidiary is treated as a single corporation with the parent pursuant to Q/A–46) and to mergers involving the creation of a new corporation or with respect to the corporation that is not surviving entity.

(b) (1) There is no change in ownership or control under this A–29 when there is a transfer to an entity that is controlled by the shareholders of the transferring corporation immediately after the transfer, as provided in this paragraph (b). A transfer of assets by a corporation is not treated as a change in the ownership of such assets if the assets are transferred to—

(i) A shareholder of the corporation (immediately before the asset transfer) in exchange for or with respect to its stock;

(ii) An entity, 50 percent or more of the total value or voting power of which is owned, directly or indirectly, by the corporation;

(iii) A person, or more than one person acting as a group, that owns, directly or indirectly, 50 percent or more of the total value or voting power of all the outstanding stock of the corporation; or

(iv) An entity, at least 50 percent of the total value or voting power is owned, directly or indirectly, by a person described in paragraph (b)(1)(iii) of this A–29.

(2) For purposes of paragraph (b) and except as otherwise provided, a person's status is determined immediately after the transfer of the assets. For example, a transfer to a corporation in which the transferor corporation has no ownership interest in before the transaction, but which is a majority-owned subsidiary of the transferor corporation after the transaction is not treated as a change in the ownership of the assets of the transferor corporation.

(c) For purposes of this A–29, persons will not be considered to be acting as a group merely because they happen to purchase assets of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of assets, or similar business transaction with the corporation. If a person, including an entity shareholder, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only to the extent of the ownership in that corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation.

(d) For purposes of determining stock ownership, see Q/A–27(c).

(e) The following examples illustrate the principles of this A–29:

Example 1. Corporation M acquires assets having a gross fair market value of $500,000 from Corporation N (an unrelated corporation) on January 1, 2006. The total gross fair market value of Corporation N's assets immediately prior to the acquisition was $3 million. Since the value of the assets acquired by Corporation M is less than one-third of the total gross fair market value of Corporation N's total assets immediately prior to the acquisition, the acquisition does not represent a change in the ownership of a substantial portion of Corporation N's assets.

Example 2. Assume the same facts as in *Example 1.* Also assume that on November 1, 2006, Corporation M acquires from Corporation N additional assets having a fair market value of $700,000. Thus, Corporation M has acquired from Corporation N assets worth a total of $1.2 million during the 12-month period ending on November 1, 2006. Since $1.2 million is more than one-third of the total gross fair market value of all of Corporation N's assets immediately prior to the earlier of these acquisitions ($3 million), a change in the ownership of a substantial portion of Corporation N's assets is considered to have occurred on November 1, 2006.

Example 3. (i) All of the assets of Corporation P are transferred to Corporation O (an unrelated corporation). In exchange, the shareholders of Corporation P receive Corporation O stock. Immediately after the transfer, the former shareholders of Corporation P own 60 percent of the fair market value of the outstanding stock of Corporation O and the former shareholders of Corporation O own 40 percent of the fair market value of the outstanding stock of Corporation O. Because Corporation O is an entity more than 50 percent of the fair market value of the outstanding stock of which is owned by the former shareholders of Corporation P (based on ownership of Corporation P prior the change), the transfer of assets is not treated as a change in ownership of a substantial portion of the assets of Corporation P. However, a change in the ownership (within the meaning of Q/A–27) of Corporation O occurs.

(ii) The result in paragraph (i) would be the same if immediately after the change, the former shareholders of Corporation P own stock with a fair market value of 51 percent of the value of Corporation O stock because Corporation O is an entity more than 50 percent of the fair market value of the outstanding stock of which is owned by the former shareholders of Corporation P. See Q/A–27, *Example 4,* regarding whether there is a change in ownership or control of O.

Example 4. Corporation P sells all of the stock of its wholly-owned subsidiary, S, to Corporation Y. The fair market value of the affiliated group, determined without regard to its liabilities, is $210 million. The fair market value of S, determined without regard to its liabilities, is $80 million. Because there is a change in more than one-third of the gross fair market value of the total assets of the affiliated group, there is a change in the ownership of a substantial portion of the assets of the affiliated group.

Three-Times-Base-Amount Test for Parachute Payments

Q–30: Are all payments that are in the nature of compensation, are made to a disqualified individual, and are contingent on a change in ownership or control, parachute payments?

A–30: (a) No. To determine whether such payments are parachute payments, they must be tested against the individual's *base amount* (as defined in Q/A–34 of this section). To do this, the aggregate present value of all payments in the nature of compensation that are made or to be made to (or for the benefit of) the same disqualified individual and are contingent on the change in ownership or control must be determined. If this aggregate present value equals or exceeds the amount equal to 3 times the individual's base amount, the payments are parachute payments. If this aggregate present value is less than the amount equal to 3 times the individual's base amount, no portion of the payment is a parachute payment. See Q/A–31, Q/A–32, and Q/A–33 of this section for rules on determining present value. Parachute payments that are securities violation parachute payments are not included in the foregoing computation if they are not contingent on a change in ownership or control. See Q/A–37 of this section for the definition and treatment of securities violation parachute payments.

(b) The following examples illustrate the principles of this A–30:

Example 1. A is a disqualified individual with respect to Corporation M. A's base amount is $100,000. Payments in the nature of compensation that are contingent on a change in the ownership or control of Corporation M totaling $400,000 are made to A on the date of the change in ownership or control. The payments are parachute payments because they have an aggregate present value at least equal to 3 times A's base amount of $100,000 (3 x $100,000 = $300,000).

Example 2. Assume the same facts as in *Example 1,* except that the payments contingent on the change in the ownership or control of Corporation M total $290,000. Because the payments do not have an aggregate present value at least equal to 3 times A's base amount, no portion of the payments is a parachute payment.

Q–31: As of what date is the present value of a payment determined?

A–31: (a) Except as provided in this section, the present value of a payment is determined as of the date on which the change in ownership or control occurs, or, if a payment is made prior to such date, the date on which the payment is made.

(b)(1) For purposes of determining whether a payment is a parachute payment, if a payment in the nature of compensation is the right to receive payments in a year (or years) subsequent to the year of the change in ownership or control, the value of the payment is the present value of such payment (or payments) calculated in accordance with Q/A–32 of this section and based on reasonable actuarial assumptions.

(2) If the payment in the nature of compensation is an obligation to provide health care, then for purposes of this A–31 and for applying the 3-times-base-amount test under Q/A–30 of this section, the present value of such obligation should be calculated in accordance with generally accepted accounting principles. For purposes of Q/A–30 and this A–31, the obligation to provide health care is permitted to be measured by projecting the cost of premiums for purchased health care insurance, even if no health care insurance is actually purchased. If the obligation to provide health care is made in coordination with a health care plan that the corporation makes available to a group, then the premiums used for this purpose may be group premiums.

Q–32: What discount rate is to be used to determine present value?

A–32: For purposes of this section, present value generally is determined by using a discount rate equal to 120 percent of the applicable Federal rate (determined under section 1274(d) and the regulations thereunder) compounded semiannually. The applicable Federal rate to be used for this purpose is the Federal rate that is in effect on the date as of which the present value is determined, using the period until the payment would have been made without regard to the change in ownership or control as the term of the debt instrument under section 1274(d). See Q/A–24 and 31 of this section. However, for any payment, the corporation and the disqualified individual may elect to use the applicable Federal rate that is in effect on the date that the contract which provides for the payment is entered into, if such election is made in the contract.

Q–33: If the present value of a payment to be made in the future is contingent on an uncertain future event or condition, how is the present value of the payment determined?

A–33: (a) In certain cases, it may be necessary to apply the 3-times-base-amount test of Q/A–30 of this section, or to allocate a portion of the base amount to a payment described in paragraphs (a)(1), (2), and (3) of Q/A–2 of this section, at a time when the aggregate present value of all such payments cannot be determined with certainty because the time, amount, or right to receive one or more such payments is contingent on the occurrence of an uncertain future event or condition. For example, a disqualified individual's right to receive a payment may be contingent on the involuntary termination of such individual's employment with the corporation. In such a case, it must be reasonably estimated whether the payment will be made. If it is reasonably estimated that there is a 50-percent or greater probability that the payment will be made, the full amount of the payment is considered for purposes of the 3-times-base-amount test and the allocation of the base amount. Conversely, if it is reasonably estimated that there is a less than 50-percent probability that the payment will be made, the payment is not considered for either purpose.

(b) If the estimate made under paragraph (a) of this A–33 is later determined to be incorrect, the 3-times-base-amount test described in Q/A–30 of this section must be reapplied (and the portion of the base amount allocated to previous payments must be reallocated (if necessary) to such payments) to reflect the actual time and amount of the payment. Whenever the 3-times-base-amount test is applied (or whenever the base amount is allocated), the aggregate present value of the payments received or to be received by the disqualified individual is redetermined as of the date described in A–31 of this section, using the discount rate described in A–32 of this section. This redetermination may affect the amount of any excess parachute payment for a prior taxable year. Alternatively, if, based on the application of the 3-times-base-amount test without regard to the payment described in paragraph (a) of this A–33, a disqualified individual is determined to have an excess parachute payment or payments, then the 3-times-base-amount test does not have to be reapplied when a payment described in paragraph (a) of this A–33 is made (or becomes certain to be made) if no base amount is allocated to such payment.

(c) To the extent provided in published guidance of general applicability under § 601.601(d)(2) of this Chapter, an initial estimate of the value of an option subject to Q/A–13 of this section is permitted to be made, with the valuation subsequently re-determined, and the 3-times-base-amount test reapplied.

(d) The following examples illustrate the principles of this A–33:

Example 1. A, a disqualified individual with respect to Corporation M, has a base amount of $100,000. Under A's employment agreement with Corporation M, A is entitled to receive a payment in the nature of compensation in the amount of $250,000 contingent on a change in ownership or control of Corporation M. In addition, the agreement provides that if A's employment is terminated within 1 year after the change in ownership or control, A will receive an additional payment in the nature of compensation in the amount of $150,000, payable 1 year after the date of the change in ownership or control. A change in ownership or control of Corporation M occurs and A receives the first payment of $250,000. Corporation M reasonably estimates that there is a 50-percent probability that, as a result of the change, A's employment will be terminated within 1 year of the date of the change. For purposes of applying the 3-times-base-amount test (and if the first payment is determined to be a parachute payment, for purposes of allocating a portion of A's base amount to that payment), because M reasonably estimates that there is a 50-percent or greater probability that, as a result of the change, A's employment will be terminated within 1 year of the date of the change, Corporation M must assume that the $150,000 payment will be made to A as a result of the change in ownership or control. The present value of the additional payment is determined under Q/A–31 and Q/A–32 of this section.

Example 2. Assume the same facts as in *Example 1,* except that Corporation M reasonably estimates that there is a less than 50-percent probability that, as a result of the change, A's employment will be terminated within 1 year of the date of the change. For purposes of applying the 3-times-base-amount test, because Corporation M reasonably estimates that there is a less than 50-percent probability that, as a result of the change, A's employment will be terminated within 1 year of the date of the change, Corporation M must assume that the $150,000 payment will not be made to A as a result of the change in ownership or control.

Example 3. B, a disqualified individual with respect to Corporation P, has a base amount of $200,000. Under B's employment agreement with Corporation P, if there is a change in ownership or control of Corporation P, B will receive a severance payment of $600,000 and a bonus payment of $400,000. In addition, the agreement provides that if B's employment is terminated within 1 year after the change, B will receive an additional payment in the nature of compensation of $500,000. A change in ownership or control of Corporation P occurs, and B receives the $600,000 and $400,000 payments. At the time of the change in ownership or control, Corporation P reasonably estimates that there is a less than 50-percent probability that B's employment will be terminated within 1 year of the change. For purposes of applying the 3-times-base-amount test, because Corporation P reasonably estimates that there is a less than 50-percent probability that B's employment will be terminated within 1 year of the date of the change, Corporation P assumes that the $500,000 payment will not be made to B. Eleven months after the change in ownership or control, B's employment is terminated, and the $500,000 payment is made to B. Because B was determined to have excess parachute payments without regard to the $500,000 payment, the 3-times-base-amount test is not reapplied and the base amount is not reallocated to include the $500,000 payment. The entire $500,000 payment is treated as an excess parachute payment.

Q–34: What is the base amount?

A–34: (a) The base amount of a disqualified individual is the average annual compensation for services performed for the corporation with respect to which the change in ownership or control occurs (or for a predecessor entity or a related entity as defined in Q/A–21 of this section) which was includible in the gross income of such individual for taxable years in the base period (including amounts that were excluded under section 911), or which would have been includible in such gross income if such person had been a United States citizen or resident. *See* Q/A–35 of this section for the definition of base period and for examples of base amount computations.

(b) If the base period of a disqualified individual includes a short taxable year or less than all of a taxable year, compensation for such short or incomplete taxable year must be annualized before determining the average annual compensation for the base period. In annualizing compensation, the frequency with which payments are expected to be made over an annual period must be taken into account. Thus, any amount of compensation for such a short or incomplete taxable year that represents a payment that will not be made more often than once per year is not annualized.

(c) Because the base amount includes only compensation that is includible in gross income, the base amount does not include certain items that constitute parachute payments. For example, payments in the form of excludible fringe benefits are not included in the base amount but may be treated as parachute payments.

(d) The base amount includes the amount of compensation included in income under section 83(b) during the base period. *See* Q/A–35 for the definition of base period.

(e) The following example illustrates the principles of this A–34:

Example. A disqualified individual, D, receives an annual salary of $500,000 per year during the 5-year base period. D defers $100,000 of D's salary each year under the corporation's nonqualified deferred compensation plan. D's base amount is $400,000 ($400,000 × (5/5)).

Q–35: What is the base period?

A–35: (a) The base period of a disqualified individual is the most recent 5 taxable years of the individual ending before the date of the change in ownership or control. For this purpose, the date of the change in ownership or control is the date the corporation experiences one of the events described in Q/A–27, Q/A–28, or Q/A–29 of this section. However, if the disqualified individual was not an employee or independent contractor of the corporation with respect to which the change in ownership or control occurs (or a predecessor entity or a related entity as defined in Q/A–21 of this section) for this entire 5-year period, the individual's base period is the portion of such 5-year period during which the individual performed personal services for the corporation or predecessor entity or related entity.

(b) The following examples illustrate the principles of Q/A–34 of this section and this Q/A–35:

Example 1. A disqualified individual, D, was employed by a corporation for 2 years and 4 months preceding the taxable year in which a change in ownership or control of the corporation occurs. D's includible compensation income from the corporation was $30,000 for the 4-month period, $120,000 for the first full year, and $150,000 for the second full year. D's base amount is $120,000, ((3 × $30,000) + $120,000 + $150,000)/3.

Example 2. Assume the same facts as in *Example 1,* except that D also received a $60,000 signing bonus when D's employment with the corporation commenced at the beginning of the 4-month period. D's base amount is $140,000, (($60,000 + (3 × $30,000)) + $120,000 + $150,000) / 3. Since the bonus will not be paid more often than once per year, the amount of the bonus is not increased in annualizing D's compensation for the 4-month period.

Example 3. E is a disqualified individual with respect to Corporation X who was not an employee or independent contractor for the full 5-year base period. In 2004 and 2005, E is a director of X and receives $30,000 per year for E's services. In 2006, E becomes an officer of X. E's includible compensation from Corporation X is $250,000 for 2006 and 2007, and $300,000 for 2008. In 2008, X undergoes a change in ownership or control. E's base amount is $140,000 ((2 × $250,000) + (2 × $30,000)/4).

Q–36: How is the base amount determined in the case of a disqualified individual who did not perform services for the corporation (or a predecessor entity or a related entity as defined in Q/A–21 of this section), prior to the individual's taxable year in which the change in ownership or control occurs?

A–36: (a) In such a case, the individual's base amount is the annualized compensation for services performed for the corporation (or a predecessor entity or related entity) which—

(1) Was includible in the individual's gross income for that portion, prior to such change, of the individual's taxable year in which the change occurred (including amounts that were excluded under section 911), or would have been includible in such gross income if such person had been a United States citizen or resident;

(2) Was not contingent on the change in ownership or control; and

(3) Was not a securities violation parachute payment.

(b) The following examples illustrate the principles of this A–36:

Example 1. On January 1, 2006, A, an individual whose taxable year is the calendar year, enters into a 4-year employment contract with Corporation M as an officer of the corporation. A has not previously performed services for Corporation M (or any predecessor entity or related entity as defined in Q/A–21 of this section). Under the employment contract, A is to receive an annual salary of $120,000 for each of the 4 years that he remains employed by Corporation M with any remaining unpaid balance to be paid immediately in the event that A's employment is terminated without cause. On July 1, 2006, after A has received compensation of $60,000, a change in the ownership or control of Corporation M occurs. Because of the change, A's employment is terminated without cause, and he receives a payment of $420,000. It is established by clear and convincing evidence that the $60,000 in compensation is not contingent on the change in ownership or control, but the presumption that the $420,000 payment is contingent on the change is not rebutted. Thus, the payment of $420,000 is treated as contingent on the change in ownership or control of Corporation M. In this case, A's base amount is $120,000 (2 × $60,000). Since the present value of the payment which is contingent on the change in ownership of Corporation M ($420,000) is more than 3 times A's base amount of $120,000 (3 × $120,000 = $360,000), the payment is a parachute payment.

Example 2. Assume the same facts as in *Example 1,* except that A also receives a signing bonus of $50,000 from Corporation M on January 1, 2006. It is established by clear and convincing evidence that the bonus is not contingent on the change in ownership or control. When the change in ownership or control occurs on July 1, 2006, A has received compensation of $110,000 (the $50,000 bonus plus $60,000 in salary). In this case, A's base amount is $170,000 ($50,000 + (2 × $60,000)). Because the $50,000 bonus will not be paid more than once per year, the amount of the bonus is not increased in annualizing A's compensation. The present value of the potential parachute payment ($420,000) is less than 3 times A's base amount of $170,000 (3 × $170,000 = $510,000), and therefore no portion of the payment is a parachute payment.

Securities Violation Parachute Payments

Q–37: Must a payment be contingent on a change in ownership or control in order to be a parachute payment?

A–37: (a) No, the term *parachute payment* also includes any payment (other than a payment exempted under Q/A–6 or Q/A–8 of this section) that is in the nature of compensation and is to (or for the benefit of) a disqualified individual, if such payment is a securities violation payment. A securities violation payment is a payment made or to be made—

(1) Pursuant to an agreement that violates any generally enforced Federal or state securities laws or regulations; and

(2) In connection with a potential or actual change in ownership or control.

(b) A violation is not taken into account under paragraph (a)(1) of this A–37 if it is merely technical in character or is not materially prejudicial to shareholders or potential shareholders. Moreover, a violation will be presumed not to exist unless the existence of the violation has been determined or admitted in a civil or criminal action (or an administrative action by a regulatory body charged with enforcing the particular securities law or regulation) which has been resolved by adjudication or consent. Parachute payments described in this A–37 are referred to in this section as securities violation payments.

(c) Securities violation parachute payments that are not contingent on a change in ownership or control within the meaning of Q/A–22 of this section are not taken into account in applying the 3-times-base-amount test of Q/A–30 of this section. Such payments are considered parachute payments regardless of whether such test is met with respect to the disqualified individual (and are included in allocating base amount under Q/A–38 of this section). Moreover, the amount of a securities violation parachute payment treated as an excess parachute payment shall not be reduced by the portion of such payment that is reasonable compensation for personal services actually rendered before the date of a change in ownership or control if such payment is not contingent on such change. Likewise, the amount of a securities violation parachute payment includes the portion of such payment that is reasonable compensation for personal services to be rendered on or after the date of a change in ownership or control if such payment is not contingent on such change.

(d) The rules in paragraph (b) of this A–37 also apply to securities violation parachute payments that are contingent on a change in ownership or control if the application of these rules results in greater total excess parachute payments with respect to the disqualified individual than would result if the payments were treated simply as payments contingent on a change in ownership or control (and hence were taken into account in applying the 3-times-base-amount test and were reduced by, or did not include, any applicable amount of reasonable compensation).

(e) The following examples illustrate the principles of this A–37:

Example 1. A, a disqualified individual with respect to Corporation M, receives two payments in the nature of compensation that are contingent on a change in the ownership or control of Corporation M. The present value of the first payment is equal to A's base amount and is not a securities violation parachute payment. The present value of the second payment is equal to 1.5 times A's base amount and is a securities violation parachute payment. Neither payment includes any reasonable compensation. If the second payment is treated simply as a payment contingent on a change in ownership or control, the amount of A's total excess parachute payments is zero because the aggregate present value of the payments does not equal or exceed 3 times A's base amount. If the second payment is treated as a securities violation parachute payment subject to the rules of paragraph (b) of this A–37, the amount of A's total excess parachute payments is 0.5 times A's base amount. Thus, the second payment is treated as a securities violation parachute payment.

Example 2. Assume the same facts as in *Example 1*, except that the present value of the first payment is equal to 2 times A's base amount. If the second payment is treated simply as a payment contingent on a change in ownership or control, the total present value of the payments is 3.5 times A's base amount, and the amount of A's total excess parachute payments is 2.5 times A's base amount. If the second payment is treated as a securities violation parachute payment, the amount of A's total excess parachute payments is 0.5 times A's base amount. Thus, the second payment is treated simply as a payment contingent on a change in ownership or control.

Example 3. B, a disqualified individual with respect to Corporation N, receives two payments in the nature of compensation that are contingent on a change in the control of Corporation N. The present value of the first payment is equal to 4 times B's base amount and is a securities violation parachute payment. The present value of the second payment is equal to 2 times B's base amount and is not a securities violation parachute payment. B establishes by clear and convincing evidence that the entire amount of the first payment is reasonable compensation for personal services to be rendered after the change in ownership or control. If the first payment is treated simply as a payment contingent on a change in ownership or control, it is exempt from the definition of *parachute payment* pursuant to Q/A–9 of this section. Thus, the amount of B's total excess parachute payment is zero because the present value of the second payment does not equal or exceed 3 times B's base amount. However, if the first payment is treated as a securities violation parachute payment, the amount of B's total excess parachute payments is 3 times B's base amount. Thus, the first payment is treated as a securities violation parachute payment.

Example 4. Assume the same facts as in *Example 3*, except that B does not receive the second payment and B establishes by clear and convincing evidence that the first payment is reasonable compensation for services actually rendered before the change in the control of Corporation N. If the payment is treated simply as a payment contingent on a change in ownership or control, the amount of B's excess parachute payment is zero because the amount treated as an excess parachute payment is reduced by the amount that B establishes as reasonable compensation. However, if the payment is treated as a securities violation parachute payment, the amount of B's excess parachute payment is 3 times B's base amount. Thus, the payment is treated as a securities violation parachute payment.

Computation and Reduction of Excess Parachute Payments

Q–38: How is the amount of an excess parachute payment computed?

A–38: (a) The amount of an excess parachute payment is the excess of the amount of any parachute payment over the portion of the disqualified individual's base amount that is allocated to such payment. For this purpose, the portion of the base amount allocated to any parachute payment is the amount that bears the same ratio to the base amount as the present value of such parachute payment bears to the aggregate present value of all parachute payments made or to be made to (or for the benefit of) the same disqualified individual. Thus, the portion of the base amount allocated to any parachute payment is determined by multiplying the base amount by a fraction, the numerator of which is the present value of such parachute payment and the denominator of which is the aggregate present value of all such payments. *See* Q/A–31, Q/A–32, and Q/A–33 of this section for rules on determining present value and Q/A–34 of this section for the definition of *base amount.*

(b) The following example illustrates the principles of this A–38:

Example. An individual with a base amount of $100,000 is entitled to receive two parachute payments, one of $200,000 and the other of $400,000. The $200,000 payment is made at the time of the change in ownership or control, and the $400,000 payment is to be made at a future date. The present value of the $400,000 payment is $300,000 on the date of the change in ownership or control. The portions of the base amount allocated to these payments are $40,000 (($200,000/$500,000) × $100,000) and $60,000 (($300,000/$500,000) × $100,000), respectively. Thus, the amount of the first excess parachute payment is $160,000 ($200,000 − $40,000) and that of the second is $340,000 ($400,000 − $60,000).

Q–39: May the amount of an excess parachute payment be reduced by reasonable compensation for personal services actually rendered before the change in ownership or control?

A–39: (a) Generally, yes. Except in the case of payments treated as securities violation parachute payments or when the portion of a payment that is treated as contingent on the change in ownership or control is determined under paragraph (b) or (c) of Q/A–24 of this section, the amount of an excess parachute payment is reduced by any portion of the payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered by the disqualified individual before the date of the change in ownership or control. Services reasonably compensated for by payments that are not parachute payments (for example, because the payments are not contingent on a change in ownership or control and are not securities violation parachute payments, or because the payments are exempt from the definition of parachute payment under Q/A–6 through Q/A–9 of this section) are not taken into account for this purpose. The portion of any parachute payment that is established as reasonable compensation is first reduced by the portion of the disqualified individual's base amount that is allocated to such parachute payment; any remaining portion of the parachute payment established as reasonable compensation then reduces the excess parachute payment.

(b) The following examples illustrate the principles of this A–39:

Example 1. Assume that a parachute payment of $600,000 is made to a disqualified individual, and the portion of the individual's base amount that is allocated to the parachute payment is $100,000. Also assume that $300,000 of the $600,000 parachute payment is established as reasonable compensation for personal services actually rendered by the disqualified individual before the date of the change in ownership or control. Before the reasonable compensation is taken into account, the amount of the excess parachute payment is $500,000 ($600,000—$100,000). In reducing the excess parachute payment by reasonable compensation, the portion of the parachute payment that is established as reasonable compensation ($300,000) is first reduced by the portion of the disqualified individual's base amount that is allocated to the parachute payment ($100,000), and the remainder ($200,000) then reduces the excess parachute payment. Thus, in this case, the excess parachute payment of $500,000 is reduced by $200,000 of reasonable compensation.

Example 2. Assume the same facts as in *Example 1*, except that the full amount of the $600,000 parachute payment is established as reasonable compensation. In this case, the excess parachute payment of $500,000 is reduced to zero by $500,000 of reasonable compensation. As a result, no portion of any deduction for the payment is disallowed by section 280G, and no portion of the payment is subject to the 20-percent excise tax of section 4999.

Determination of Reasonable Compensation

Q–40: How is it determined whether payments are reasonable compensation?

A–40: (a) In general, whether payments are reasonable compensation for personal services actually rendered, or to be rendered, by the disqualified individual is determined on the basis of all the facts and circumstances of the particular case. Factors relevant to such a determination include, but are not limited to, the following—

(1) The nature of the services rendered or to be rendered;

(2) The individual's historic compensation for performing such services; and

(3) The compensation of individuals performing comparable services in situations where the compensation is not contingent on a change in ownership or control.

(b) For purposes of section 280G, reasonable compensation for personal services includes reasonable compensation for holding oneself out as available to perform services and refraining from performing services (such as under a covenant not to compete).

Q–41: Is any particular type of evidence generally considered clear and convincing evidence of reasonable compensation for personal services?

A–41: Yes. A showing that payments are made under a nondiscriminatory employee plan or program (as defined in Q/A–26 of this section) generally is considered to be clear and convincing evidence that the payments are reasonable compensation. This is true whether the personal services for which the payments are made are actually rendered before, or are to be rendered on or after, the date of the change in ownership or control. Q/A–46 of this section (relating to the treatment of an affiliated group as one corporation) does not apply for purposes of this A–41. No determination of reasonable compensation is needed for payments under qualified plans to be exempt from the definition of *parachute payment* under Q/A–8 of this section.

Q–42: Is any particular type of evidence generally considered clear and convincing evidence of reasonable compensation for personal services to be rendered on or after the date of a change in ownership or control?

A–42: (a) Yes, if payments are made or to be made to (or on behalf of) a disqualified individual for personal services to be rendered on or after the date of a change in ownership or control, a showing of the following generally is considered to be clear and convincing evidence that the payments are reasonable compensation for services to be rendered on or after the date of the change in ownership or control—

(1) The payments were made or are to be made only for the period the individual actually performs such personal services; and

(2) If the individual's duties and responsibilities are substantially the same after the change in ownership or control, the individual's annual compensation for such services is not significantly greater than such individual's annual compensation prior to the change in ownership or control, apart from normal increases attributable to increased responsibilities or cost of living adjustments. If the scope of the individual's duties and responsibilities are not substantially the same, the annual compensation after the change is not significantly greater than the annual compensation customarily paid by the employer or by comparable employers to persons performing comparable services. However, except as provided in paragraph (b) and (c) of this A–42, such clear and convincing evidence will not exist if the individual does not, in fact, perform the services contemplated in exchange for the compensation.

(b) Generally, an agreement under which the disqualified individual must refrain from performing services (*e.g.*, a covenant not to compete) is an agreement for the performance of personal services for purposes of this A–42 to the extent that it is demonstrated by clear and convincing evidence that the agreement substantially constrains the individual's ability to perform services and there is a reasonable likelihood that the agreement will be enforced against the individual. In the absence of clear and convincing evidence, payments under the agreement are treated as severance payments under Q/A–44 of this section.

(c) If the employment of a disqualified individual is involuntarily terminated before the end of a contract term and the individual is paid damages for breach of contract, a showing of the following factors generally is considered clear and convincing evidence that the payment is reasonable compensation for personal services to be rendered on or after the date of change in ownership or control—

(1) The contract was not entered into, amended, or renewed in contemplation of the change in ownership or control;

(2) The compensation the individual would have received under the contract would have qualified as reasonable compensation under section 162;

(3) The damages do not exceed the present value (determined as of the date of receipt) of the compensation the individual would have received under the contract if the individual had continued to perform services for the employer until the end of the contract term;

(4) The damages are received because an offer to provide personal services was made by the disqualified individual but was rejected by the employer (including involuntary termination or constructive discharge); and

(5) The damages are reduced by mitigation. Mitigation will be treated as occurring when such damages are reduced (or any payment of such damages is returned) to the extent of the disqualified individual's earned income (within the meaning of section 911(d)(2)(A)) during the remainder of the period in which the contract would have been in effect. See Q/A–44 of this section for rules regarding damages for a failure to make severance payments.

(d) The following examples illustrate the principles of this A–42:

Example 1. A, a disqualified individual, has a three-year employment contract with Corporation M, a publicly traded corporation. Under this contract, A is to receive a salary for $100,000 for the first year of the contract and, for each succeeding year, an annual salary that is 10 percent higher than the prior year's salary. During the third year of the contract, Corporation N acquires all the stock of Corporation M. Prior to the change in ownership, Corporation N arranges to retain A's services by entering into an employment contract with A that is essentially the same as A's contract with Corporation M. Under the new contract, Corporation N is to fulfill Corporation M's obligations for the third year of the old contract, and, for each of the succeeding years, pay A an annual salary that is 10 percent higher than A's prior year's salary. Amounts are payable under the new contract only for the portion of the contract term during which A remains employed by Corporation N. A showing of the facts described above (and in the absence of contradictory evidence) is regarded as clear and convincing evidence that all payments under the new contract are reasonable compensation for personal services to be rendered on or after the date of the change in ownership. Therefore, the payments under this agreement are exempt from the definition of *parachute payment* pursuant to Q/A–9 of this section.

Example 2. Assume the same facts as in *Example 1,* except that A does not perform the services described in the new contract, but receives payment under the new contract. Because services were not rendered after the change, the payments under this contract are not exempt from the definition of *parachute payment* pursuant to Q/A–9 of this section.

Example 3. Assume the same facts as in *Example 1,* except that under the new contract A agrees to perform consulting services to Corporation N, when and if Corporation N requires A's services. Assume further that when Corporation N does not require A's services, the contract provides that A must not perform services for any other competing company. Corporation N previously enforced similar contracts against former employees of Corporation N. Because A is substantially constrained under this contract and Corporation N is reasonably likely to enforce the contract against A, the agreement is an agreement for the performance of services under paragraph (b) of this A–42. Assuming the requirements of paragraph (a) of this A–42 are met and there is clear and convincing evidence that all payments under the new contract are reasonable compensation for personal services to be rendered on or after the date of the change in ownership, the payments under this contract are exempt from the definition of *parachute payment* pursuant to Q/A–9 of this section.

Example 4. Assume the same facts as in *Example 1,* except that instead of agreeing not to compete with Corporation N, under the new agreement A agrees not to disparage either Corporation M or Corporation N. Because the nondisparagement agreement does not substantially constrain A's ability to perform services, no amount of the payments under this contract are reasonable compensation for the nondisparagement agreement.

Example 5. Assume the same facts as in *Example 1,* except that the employment contract with Corporation N does not provide that amounts are payable under the contract only for the portion of the term for which A remains employed by Corporation N. Shortly after the change in ownership, and despite A's request to remain employed by Corporation N, A's employment with Corporation N is involuntarily terminated. Shortly thereafter, A obtains employment with Corporation O. A commences a civil action against Corporation N, alleging breach of the employment contract. In settlement of the litigation, A receives an amount equal to the present value of the compensation A would have received under the contract with Corporation N, reduced by the amount of compensation A otherwise receives from Corporation O during the period that the contract would have been in effect. A showing of the facts described above (and in the absence of contradictory evidence) is regarded as clear and convincing evidence that the amount A receives as damages is reasonable compensation for personal services to be rendered on or after the date of the change in ownership. Therefore, the amount received by A is exempt from the definition of *parachute payment* pursuant to Q/A–9 of this section.

Q–43: Is any particular type of payment generally considered reasonable compensation for personal services actually rendered before the date of a change in ownership or control?

A–43: Yes, payments of compensation earned before the date of a change in ownership or control generally are considered reasonable compensation for personal services actually rendered before the date of a change in ownership or control if they qualify as reasonable compensation under section 162.

Q–44: May severance payments be treated as reasonable compensation?

A–44: (a) No, severance payments are not treated as reasonable compensation for personal services actually rendered before, or to be rendered on or after, the date of a change in ownership or control. Moreover, any damages paid for a failure to make severance payments are not treated as reasonable compensation for personal services actually rendered before, or to be rendered on or after, the date of such change. For purposes of this section, the term *severance payment* means any payment that is made to (or for the benefit of) a disqualified individual on account of the termination of such individual's employment prior to the end of a contract term, but does not include any payment that otherwise would be made to (or for the benefit of) such individual on the termination of such individual's employment, whenever occurring.

(b) The following example illustrates the principles of this A–44:

Example. A, a disqualified individual, has a three-year employment contract with Corporation X. Under the contract, A will receive a salary of $200,000 for the first year of the contract, and for each succeeding year, an annual salary that is $100,000 higher than the previous year. In the event of A's termination of employment following a change in ownership or control, the contract provides that A will receive the remaining salary due under the employment contract. At the beginning of the second year of the contract, Corporation Y acquires all of the stock of Corporation X, A's employment is terminated, and A receives $700,000 ($300,000 for the second year of the contract plus $400,000 for the third year of the contract) representing the remaining salary due under the employment contract. Because the $700,000 payment is treated as a severance payment, it is not reasonable compensation for personal services on or after the date of the change in ownership or control. Thus, the full amount of the $700,000 is a parachute payment.

Miscellaneous Rules

Q–45: How is the term *corporation* defined?

A–45: For purposes of this section, the term *corporation* has the meaning prescribed by section 7701(a)(3) and § 301.7701–2(b) of this Chapter. For example, a *corporation,* for purposes of this section, includes a publicly traded partnership treated as a corporation under section 7704(a); an entity described in § 301.7701–3(c)(1)(v)(A) of this Chapter; a real estate investment trust under section 856(a); a corporation that has mutual or cooperative (rather than stock) ownership, such as a mutual insurance company, a mutual savings bank, or a cooperative bank (as defined in section 7701(a)(32)), and a foreign corporation as defined under section 7701(a)(5).

Q–46: How is an affiliated group treated?

A–46: For purposes of this section, and except as otherwise provided in this section, all members of the same affiliated group (as defined in section 1504, determined without regard to section 1504(b)) are treated as one corporation. Rules affected by this treatment of an affiliated group include (but are not limited to) rules relating to exempt payments of certain corporations (Q/A–6, Q/A–7 of this section (except as provided therein)), payor of parachute payments (Q/A–10 of this section), disqualified individuals (Q/A–15 through Q/A–21 of this section (except as provided therein)), rebuttal of the presumption that payments are contingent on a change (Q/A–26 of this section (except as provide therein)), change in ownership or control (Q/A–27, 28, and 29 of this section), and reasonable compensation (Q/A–42, 43, and 44 of this section).

Effective Date

Q–47: What is the general effective date of section 280G?

A–47: (a) Generally, section 280G applies to payments under agreements entered into or renewed after June 14, 1984. Any agreement that is entered into before June 15, 1984, and is renewed after June 14, 1984, is treated as a new contract entered into on the day the renewal takes effect.

(b) For purposes of paragraph (a) of this A–47, a contract that is terminable or cancellable unconditionally at will by either party to the contract without the consent of the other, or by both parties to the contract, is treated as a new contract entered into on the date any such termination or cancellation, if made, would be effective. However, a contract is not treated as so terminable or cancellable if it can be terminated or cancelled only by terminating the employment relationship or independent contractor relationship of the disqualified individual.

(c) Section 280G applies to payments under a contract entered into on or before June 14, 1984, if the contract is amended or supplemented after June 14, 1984, in significant relevant respect. For this purpose, a *supplement* to a contract is defined as a new contract entered into after June 14, 1984, that affects the trigger, amount, or time of receipt of a payment under an existing contract.

(d)(1) Except as otherwise provided in paragraph (e) of this A–47, a contract is considered to be amended or supplemented in significant relevant respect if provisions for payments contingent on a change in ownership or control (parachute provisions), or provisions in the nature of parachute provisions, are added to the contract, or are amended or supplemented to provide significant additional benefits to the disqualified individual. Thus, for example, a contract generally is treated as amended or supplemented in significant relevant respect if it is amended or supplemented—

(i) To add or modify, to the disqualified individual's benefit, a change in ownership or control trigger;

(ii) To increase amounts payable that are contingent on a change in ownership or control (or, where payment is to be made under a formula, to modify the formula to the disqualified individual's advantage); or

(iii) To accelerate, in the event of a change in ownership or control, the payment of amounts otherwise payable at a later date.

(2) For purposes of paragraph (a) of this A–47, a payment is not treated as being accelerated in the event of a change in ownership or control if the acceleration does not increase the present value of the payment.

(e) A contract entered into on or before June 14, 1984, is not treated as amended or supplemented in significant relevant respect merely by reason of normal adjustments in the terms of employment relationship or independent contractor relationship of the disqualified individual. Whether an adjustment in the terms of such a relationship is considered normal for this purpose depends on all of the facts and circumstances of the particular case. Relevant factors include, but are not limited to, the following—

(1) The length of time between the adjustment and the change in ownership or control;

(2) The extent to which the corporation, at the time of the adjustment, viewed itself as a likely takeover candidate;

(3) A comparison of the adjustment with historical practices of the corporation;

(4) The extent of overlap between the group receiving the benefits of the adjustment and those members of that group who are the beneficiaries of pre-June 15, 1984, parachute contracts; and

(5) The size of the adjustment, both in absolute terms and in comparison with the benefits provided to other members of the group receiving the benefits of the adjustment.

Q–48: What is the effective date of this section?

A–48: This section applies to any payments that are contingent on a change in ownership or control if the change in ownership or control occurs on or after January 1, 2004.

■ **Par 3.** In § 602.101, paragraph (b) is amended by adding an entry in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * *	* *
1.280G–1	1545–1851

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Robert E. Wenzel,

Deputy Commissioner for Services and Enforcement.

Approved: July 14, 2003.

Pamela F. Olson,

Assistant Secretary of the Treasury.

[FR Doc. 03–19274 Filed 8–1–03; 8:45 am]

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9085]

RIN 1545–AY12

Arbitrage and Private Activity Restrictions Applicable to Tax-exempt Bonds Issued by State and Local Governments; Investment-type Property (prepayment); Private Loan (prepayment)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations on the arbitrage and private activity restrictions applicable to tax-exempt bonds issued by State and local governments. These regulations affect issuers of tax-exempt bonds and provide guidance on the definitions of investment-type property and private loan to help issuers comply with the arbitrage and private activity restrictions.

DATES: *Effective Date:* These regulations are effective October 3, 2003.

Applicability Date: For dates of applicability, see §§ 1.141–15(b)(3) and 1.148–11(j) of these regulations.

FOR FURTHER INFORMATION CONTACT: Johanna Som de Cerff (202) 622–3980 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document amends the Income Tax Regulations (26 CFR part 1) under sections 141 and 148 of the Internal Revenue Code by providing rules for determining whether a prepayment for property or services results in a private loan or investment-type property (the final regulations). On April 17, 2002, the IRS published in the **Federal Register** a notice of proposed rulemaking (REG–113526–98; REG–105369–00) (67 FR 18835) (the proposed regulations). The proposed regulations modify §§ 1.141–5(c)(2) and 1.148–1(e) of the Income Tax Regulations to establish which prepayments for property or services give rise to a private loan under section 141(c) or investment-type property under section 148(b)(2)(D). On September 25, 2002, the IRS held a public hearing on the proposed regulations. Written comments responding to the proposed regulations were also received. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision. The revisions are discussed below.

Explanation of Provisions

I. Investment-type Property

A. Existing Regulations

The existing regulations, at § 1.148–1(e)(2), contain rules for determining when a prepayment for property or services results in investment-type property. Under that provision, a prepayment generally gives rise to investment-type property if a principal purpose for prepaying is to receive an investment return from the time the prepayment is made until the time payment otherwise would be made. However, a prepayment does not give rise to investment-type property under the existing regulations if (1) it is made for a substantial business purpose other than investment return and the issuer has no commercially reasonable alternative to the prepayment (the business purpose exception); or (2) prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax-exempt financing (the customary exception).

B. Business Purpose Exception

The proposed regulations narrow the scope of the business purpose exception. Under the proposed regulations, a prepayment meets the business purpose exception only if the primary purpose for the prepayment is to accomplish one or more substantial business purposes that (1) are unrelated to any investment return based on the time value of money and (2) cannot be accomplished without the prepayment.

Commentators suggested that the business purpose exception in the proposed regulations would have limited usefulness and that the language in the existing regulations is superior. However, as discussed in the preamble to the proposed regulations, the business purpose exception in the existing regulations was intended to be a narrow exception and has raised difficult interpretive questions. For example, in many instances it may be unclear whether the alternatives available to the issuer are ''commercially reasonable.'' The IRS and Treasury Department have considered all of the comments relating to the business purpose exception and have concluded that a standard that considers whether one or more business purposes and/or commercially reasonable alternatives exist is not an administrable test for determining whether prepayments give rise to investment-type property. Therefore, based on tax administration considerations and the broad scope of the investment-type property concept, the final regulations delete the business purpose exception. However, the final regulations provide that the Commissioner may, by published guidance, set forth additional circumstances in which a prepayment does not give rise to investment-type property.

C. Customary Exception

The proposed regulations retain the customary exception in its present form. Commentators expressed concern that the customary exception may be difficult to apply in some cases. They suggested that the regulations identify examples of prepayments that satisfy the exception. The final regulations retain the customary exception and indicate that it generally applies based on all the facts and circumstances. In addition, the final regulations contain a safe harbor under which a prepayment is deemed to satisfy the customary exception if: (1) The prepayment is made for maintenance, repair, or an extended warranty with respect to personal property (for example, automobiles or electronic equipment), or updates or maintenance or support services with respect to computer software; and (2) the same maintenance, repair, extended warranty, updates or maintenance or support services, as applicable, are regularly provided to nongovernmental persons on the same terms.

D. Certain Prepayments To Acquire a Supply of Natural Gas or Electricity

1. Prepayments for Natural Gas

The proposed regulations add an exception to the definition of investment-type property for certain natural gas prepayments that are made by or for one or more utilities that are owned by a governmental person, as defined in § 1.141–1(b) (for example, if a joint action agency acquires a natural gas supply for one or more municipal gas or electric utilities). The exception applies only if at least 95 percent of the natural gas purchased with the prepayment is to be consumed by retail customers in the service area of a municipal gas utility, or used to produce electricity that will be furnished to retail customers that a municipal electric utility is obligated to serve under state or Federal law (the *use requirement*). For this purpose, the service area of a municipal gas utility is defined as (1) any area throughout which the municipal utility provided (at all times during the five-year period ending on the issue date) gas transmission or distribution service, and any area that is contiguous to such an area, or (2) any area where the municipal utility is obligated under state or Federal law to provide gas distribution services as provided in such law.

Some commentators recommended that the 95 percent threshold be reduced to 85 percent. These commentators stated that various factors make it difficult for municipal gas utilities to determine in advance the precise quantity of gas supplies they will need to serve their customers during a given period. These factors include a limited capability to store gas and variations in demand due to circumstances beyond the utilities' control, such as economic conditions and the weather. In recognition of these unique factors, the final regulations reduce the 95 percent threshold to 90 percent.

Some commentators recommended that the use requirement apply based on the issuer's reasonable expectations as of the issue date. To ensure that the prepaid gas is consumed by retail customers in the service area of the municipal utility, the final regulations retain the requirement that the prepaid gas supply actually be used for a qualifying purpose.

Some commentators suggested that the use of natural gas to fuel the transportation of the prepaid gas supply on a pipeline should be a qualifying use under the natural gas exception. The final regulations adopt this comment. Under the final regulations, the use of gas to fuel the pipeline transportation of the prepaid gas supply is a qualifying use and is not pro-rated based on the amount of qualified and nonqualified use of the remaining prepaid gas.

Commentators indicated that most municipal gas and electric utilities do not have an obligation to serve that arises under state or Federal law. These commentators suggested replacing the ''obligation to serve'' requirement for municipal electric utilities with a service area rule that is similar to the rule for municipal gas utilities. The final regulations adopt this comment. Commentators also recommended that the definition of service area be expanded to include any area recognized as the service area of the municipal utility under state or Federal law. The final regulations adopt this comment.

Commentators requested clarification that sales to governmental persons are qualifying sales under the use test. Commentators also requested clarification that a retail customer of a municipal utility is a qualifying end-user even if the prepayment was made by or for another municipal utility. The final regulations do not provide that all sales to governmental persons, or to retail customers of a municipal utility, are qualifying sales. Rather, the final regulations clarify that, in the case of a natural gas prepayment by or for one or more municipal utilities (each, the issuing municipal utility), the use of prepaid gas is a qualifying use if the gas is: (1) Furnished to retail gas customers of the issuing municipal utility who are located in the natural gas service area of the issuing municipal utility (other than sales of gas to produce electricity for sale); (2) used by the issuing municipal utility to produce electricity that will be furnished to retail electric customers of the issuing municipal utility who are located in the electricity service area of the issuing municipal utility; (3) used by the issuing municipal utility to produce electricity that will be sold to a municipal utility and furnished to retail electric customers of the purchaser who are located in the electricity service area of the purchaser; (4) sold to a municipal utility if the requirements of (1), (2) or (3) of this paragraph are satisfied by the purchaser (treating the purchaser as the issuing municipal utility); or (5) used to fuel the transportation of the prepaid gas supply on a pipeline. Thus, for example, the sale of gas or electricity by the issuing municipal utility directly to customers of another municipal utility is not a qualifying use.

Some commentators recommended that the final regulations define ''retail customer'' as a customer that is not purchasing for resale. The final regulations provide that a retail customer is a customer that purchases natural gas or electricity, as applicable, other than for resale. The final regulations also clarify that the consumption of natural gas by a nongovernmental person to produce electricity for sale is not a qualifying use of natural gas under the 90 percent use test.

Some commentators requested clarification of which ''contiguous'' areas may be treated as part of a municipal utility's service area. One commentator suggested that contiguous areas should not be considered part of the service area. To provide clarity, and in light of the expansion of the service area definition to include any area recognized as the service area under state or Federal law, the final regulations eliminate contiguous areas from the definition of service area.

Some commentators suggested that the definition of service area should be expanded to include any area ''in which'' (rather than ''throughout which'') the municipal utility provided service during the five-year period. To ensure that the gas or electricity is consumed by customers in an area recognized as the service area of a municipal utility under state or Federal law, or throughout which the municipal utility provided service during the five-year period, the final regulations do not adopt this comment.

2. Prepayments for Electricity

Some commentators suggested that the natural gas exception should be expanded to include prepayments for electricity. These commentators stated that the restructuring of the electric power industry has affected municipal electric utilities in a manner that is similar to the effect that deregulation of the natural gas industry had on municipal gas utilities. These commentators stated that restructuring has threatened the ability of municipal electric utilities to obtain a secure supply of electric power on commercially reasonable terms, and that electric power prepayment transactions are necessary to obtain a guaranteed supply of electric power on favorable terms in light of restructuring.

The final regulations add an exception to the definition of investment-type property for certain electricity prepayments that are made by or for one or more municipal utilities (for example, if a joint action agency acquires electricity for one or more municipal electric utilities). The exception applies only if at least 90 percent of the prepaid electricity financed by the issue is used for a qualifying use. For this purpose, electricity is used for a qualifying use if it is to be: (1) Furnished to retail electric customers of the issuing municipal utility who are located in the electricity service area of the issuing municipal utility; or (2) sold to a municipal utility and furnished to retail electric customers of the purchaser who are located in the electricity service area of the purchaser.

3. Remedial Actions

The preamble to the proposed regulations states that issuers may apply principles similar to the rules of § 1.141–12 to cure a violation of the use requirement. Commentators requested clarification regarding which remedies under § 1.141–12 are available for this purpose. The final regulations provide that issuers may apply principles similar to the rules of § 1.141–12 to cure a violation of the 90 percent use requirement, and that the ''redemption or defeasance'' remedy in § 1.141–12(d) and the ''alternative use of disposition proceeds'' remedy in § 1.141–12(e) are available for this purpose.

Some commentators requested clarification of the amount of nonqualified bonds that must be redeemed or defeased under the ''redemption or defeasance'' remedy. Under the final regulations, the amount of nonqualified bonds is determined in the same manner as for output contracts taken into account under the private business tests, including the principles of § 1.141–7(d), treating nonqualified sales of gas or electricity as satisfying the benefits and burdens test under § 1.141–7(c)(1). Commentators also suggested that the definition of ''nonqualified bonds'' under § 1.141–12 may require excessive amounts of bonds to be retired. The IRS and Treasury Department are considering this comment in connection with possible amendments to § 1.141–12.

4. Commodity Swap Contracts

The proposed regulations provide that a transaction will not fail to qualify for the natural gas exception by reason of any commodity swap contract that may be entered into between the issuer and an unrelated party (other than the gas supplier), or between the gas supplier and an unrelated party (other than the issuer), so long as each swap contract is an independent contract. For this purpose, the proposed regulations provide that a swap contract is an independent contract if the obligation of each party to perform under the swap contract is not dependent on performance by any person (other than the other party to the swap contract) under another contract (for example, a gas supply contract or another swap contract). Notice 2002–52 (2002–30 I.R.B. 187), provides that a natural gas commodity swap contract will not fail to be an independent contract solely because the swap contract may terminate in the event of a failure of a gas supplier to deliver gas for which the swap contract is a hedge.

Commentators generally agreed with the provision on swap contracts in the proposed regulations, as modified by Notice 2002–52. The final regulations retain the provision on commodity swap contracts for natural gas prepayments, as modified by Notice 2002–52, and expand it to apply to electricity prepayments.

E. De Minimis Prepayments

The proposed regulations add an exception for prepayments made within 90 days of the date of delivery of all the property or services to which the prepayment relates. Commentators recommended that the exception apply based on reasonable expectations. The final regulations adopt this comment. This change to a reasonable expectations standard is intended to permit a prepayment to qualify for the de minimis exception even if an unexpected event beyond the control of the issuer causes delivery of the property or services to be delayed beyond the 90-day period. The reasonable expectations standard does not, however, apply to any change to the terms of the prepayment other than an unexpected delay in delivery.

II. Private Loans

The existing regulations, at § 1.141–5(c)(2)(ii), provide rules for determining whether a prepayment for property or services is treated as a loan for purposes of the private loan financing test. The existing regulations for private loans are similar to the existing regulations in

§ 1.148–1(e)(2) for determining whether a prepayment gives rise to investment-type property, except that the private loan regulations focus on whether the prepayment provides a benefit of tax-exempt financing to the seller. The final regulations amend the private loan provisions of § 1.141–5(c)(2) to conform to the amendments to the definition of investment-type property in the final regulations.

III. Tables of Contents

The final regulations amend the tables of contents in §§ 1.141–0 and 1.148–0 to reflect the final regulations and certain previously issued regulations under sections 141 and 148.

Effective Dates

The final regulations apply to bonds sold on or after October 3, 2003. In addition, issuers may apply the final regulations to bonds sold before October 3, 2003 that are subject to §§ 1.141–5 and 1.148–1.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the rule does not impose a collection of information on small entities, the provisions of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) do not apply.

Drafting Information

The principal authors of these regulations are Rebecca L. Harrigal and Johanna Som de Cerff, Office of Chief Counsel (TE/GE), IRS, and Stephen J. Watson, Office of Tax Policy, Treasury Department. However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

■ Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

■ **Par. 2.** Section 1.141–0 is amended by revising the entry for § 1.141–15(b) to read as follows:

§ 1.141–0 Table of contents.

* * * * *

§ 1.141–15 Effective dates.

(b) Effective dates.

(1) In general.

(2) Certain short-term arrangements.

(3) Certain prepayments.

* * * * *

■ **Par. 3.** In § 1.141–5, paragraph (c)(2)(ii) is revised and paragraphs (c)(2)(iii) and (c)(2)(iv) are added to read as follows:

§ 1.141–5 Private loan financing test.

* * * * *

(c) * * *

(2) * * *

(ii) *Certain prepayments treated as loans.* Except as otherwise provided, a prepayment for property or services, including a prepayment for property or services that is made after the date that the contract to buy the property or services is entered into, is treated as a loan for purposes of the private loan financing test if a principal purpose for prepaying is to provide a benefit of tax-exempt financing to the seller. A prepayment is not treated as a loan for purposes of the private loan financing test if—

(A) Prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax-exempt financing;

(B) The prepayment is made within 90 days of the reasonably expected date of delivery to the issuer of all of the property or services for which the prepayment is made; or

(C) The prepayment meets the requirements of § 1.148–1(e)(2)(iii)(A) or (B) (relating to certain prepayments to acquire a supply of natural gas or electricity).

(iii) *Customary prepayments.* The determination of whether a prepayment satisfies paragraph (c)(2)(ii)(A) of this section is generally made based on all the facts and circumstances. In addition, a prepayment is deemed to satisfy paragraph (c)(2)(ii)(A) of this section if—

(A) The prepayment is made for—

(*1*) Maintenance, repair, or an extended warranty with respect to personal property (for example, automobiles or electronic equipment); or

(*2*) Updates or maintenance or support services with respect to computer software; and

(B) The same maintenance, repair, extended warranty, updates or maintenance or support services, as applicable, are regularly provided to nongovernmental persons on the same terms.

(iv) *Additional prepayments as permitted by the Commissioner*. The Commissioner may, by published guidance, set forth additional circumstances in which a prepayment is not treated as a loan for purposes of the private loan financing test.

* * * * *

■ **Par. 4.** Section 1.141–15 is amended by adding paragraph (b)(3) to read as follows:

§ 1.141–15 Effective dates.

* * * * *

(b) * * *

(3) *Certain prepayments.* Except as provided in paragraph (c) of this section, paragraphs (c)(2)(ii), (c)(2)(iii) and (c)(2)(iv) of § 1.141–5 apply to bonds sold on or after October 3, 2003. Issuers may apply paragraphs (c)(2)(ii), (c)(2)(iii) and (c)(2)(iv) of § 1.141–5, in whole but not in part, to bonds sold before October 3, 2003 that are subject to § 1.141–5.

■ **Par. 5.** Section 1.148–0 is amended by:

■ 1. Adding entries in paragraph (c) for § 1.148–1, paragraphs (e)(1) through (e)(3).

■ 2. Adding entries in paragraph (c) for § 1.148–11, paragraphs (b)(4), (h), (i) and (j).

The additions read as follows:

§ 1.148–0 Scope and table of contents.

* * * * *

(c) *Table of contents.*

* * * * *

§ 1.148–1 Definitions and elections.

* * * * *

(e) * * *

(1) In general.

(2) Prepayments.

(3) Certain hedges.

* * * * *

§ 1.148–11 Effective dates.

(b) * * *

(4) No elective retroactive application for safe harbor for establishing fair market value for guaranteed investment contracts and investments purchased for a yield restricted defeasance escrow.

* * * * *

(h) Safe harbor for establishing fair market value for guaranteed investment contracts and investments purchased for a yield restricted defeasance escrow.

(i) Special rule for investments purchased for a yield restricted defeasance escrow.

(j) Certain prepayments.

■ **Par. 6.** In § 1.148–1, paragraphs (e)(1) and (2) are revised to read as follows:

§ 1.148–1 Definitions and elections.

* * * * *

(e) *Investment-type property*—(1) *In general*. Investment-type property includes any property, other than property described in section 148(b)(2)(A), (B), (C) or (E), that is held principally as a passive vehicle for the production of income. For this purpose, production of income includes any benefit based on the time value of money.

(2) *Prepayments*—(i) *In general*—(A) *Generally*. Except as otherwise provided in this paragraph (e)(2), a prepayment for property or services, including a prepayment for property or services that is made after the date that the contract to buy the property or services is entered into, also gives rise to investment-type property if a principal purpose for prepaying is to receive an investment return from the time the prepayment is made until the time payment otherwise would be made. A prepayment does not give rise to investment-type property if—

(*1*) Prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax-exempt financing;

(*2*) The prepayment is made within 90 days of the reasonably expected date of delivery to the issuer of all of the property or services for which the prepayment is made; or

(*3*) The prepayment meets the requirements of paragraph (e)(2)(iii)(A) or (B) of this section.

(B) *Example*. The following example illustrates an application of this paragraph (e)(2)(i):

Example. Prepayment after contract is executed. In 1998, City A enters into a ten-year contract with Company Y. Under the contract, Company Y is to provide services to City A over the term of the contract and in return City A will pay Company Y for its services as they are provided. In 2004, City A issues bonds to finance a lump sum payment to Company Y in satisfaction of City A's obligation to pay for Company Y's services to be provided over the remaining term of the contract. The use of bond proceeds to make the lump sum payment constitutes a prepayment for services under paragraph (e)(2)(i) of this section, even though the payment is made after the date that the contract is executed.

(ii) *Customary prepayments*. The determination of whether a prepayment satisfies paragraph (e)(2)(i)(A)(*1*) of this section is generally made based on all the facts and circumstances. In addition, a prepayment is deemed to satisfy paragraph (e)(2)(i)(A)(*1*) of this section if—

(A) The prepayment is made for—

(*1*) Maintenance, repair, or an extended warranty with respect to personal property (for example, automobiles or electronic equipment); or

(*2*) Updates or maintenance or support services with respect to computer software; and

(B) The same maintenance, repair, extended warranty, updates or maintenance or support services, as applicable, are regularly provided to nongovernmental persons on the same terms.

(iii) *Certain prepayments to acquire a supply of natural gas or electricity*—(A) *Natural gas prepayments*. A prepayment meets the requirements of this paragraph (e)(2)(iii)(A) if—

(*1*) It is made by or for one or more utilities that are owned by a governmental person, as defined in § 1.141–1(b) (each of which is referred to in this paragraph (e)(2)(iii)(A) as the issuing municipal utility), to purchase a supply of natural gas; and

(*2*) At least 90 percent of the prepaid natural gas financed by the issue is used for a qualifying use. Natural gas is used for a qualifying use if it is to be—

(*i*) Furnished to retail gas customers of the issuing municipal utility who are located in the natural gas service area of the issuing municipal utility, provided, however, that gas used to produce electricity for sale shall not be included under this paragraph (e)(2)(iii)(A)(*2*)(*i*);

(*ii*) Used by the issuing municipal utility to produce electricity that will be furnished to retail electric customers of the issuing municipal utility who are located in the electricity service area of the issuing municipal utility;

(*iii*) Used by the issuing municipal utility to produce electricity that will be sold to a utility that is owned by a governmental person and furnished to retail electric customers of the purchaser who are located in the electricity service area of the purchaser;

(*iv*) Sold to a utility that is owned by a governmental person if the requirements of paragraph (e)(2)(iii)(A)(*2*)(*i*), (*ii*) or (*iii*) of this section are satisfied by the purchaser (treating the purchaser as the issuing municipal utility); or

(*v*) Used to fuel the pipeline transportation of the prepaid gas supply acquired in accordance with this paragraph (e)(2)(iii)(A).

(B) *Electricity prepayments*. A prepayment meets the requirements of this paragraph (e)(2)(iii)(B) if—

(*1*) It is made by or for one or more utilities that are owned by a governmental person (each of which is referred to in this paragraph (e)(2)(iii)(B) as the issuing municipal utility) to purchase a supply of electricity; and

(*2*) At least 90 percent of the prepaid electricity financed by the issue is used for a qualifying use. Electricity is used for a qualifying use if it is to be—

(*i*) Furnished to retail electric customers of the issuing municipal utility who are located in the electricity service area of the issuing municipal utility; or

(*ii*) Sold to a utility that is owned by a governmental person and furnished to retail electric customers of the purchaser who are located in the electricity service area of the purchaser.

(C) *Service area*. For purposes of this paragraph (e)(2)(iii), the service area of a utility owned by a governmental person consists of—

(*1*) Any area throughout which the utility provided, at all times during the 5-year period ending on the issue date—

(*i*) In the case of a natural gas utility, natural gas transmission or distribution service; and

(*ii*) In the case of an electric utility, electricity distribution service; and

(*2*) Any area recognized as the service area of the utility under state or Federal law.

(D) *Retail customer*. For purposes of this paragraph (e)(2)(iii), a retail customer is a customer that purchases natural gas or electricity, as applicable, other than for resale.

(E) *Commodity swaps*. A prepayment does not fail to meet the requirements of this paragraph (e)(2)(iii) by reason of any commodity swap contract that may be entered into between the issuer and an unrelated party (other than the gas or electricity supplier), or between the gas or electricity supplier and an unrelated party (other than the issuer), so long as each swap contract is an independent contract. A swap contract is an independent contract if the obligation of each party to perform under the swap contract is not dependent on performance by any person (other than the other party to the swap contract) under another contract (for example, a gas or electricity supply contract or another swap contract); provided, however, that a commodity swap contract will not fail to be an independent contract solely because the swap contract may terminate in the event of a failure of a gas or electricity supplier to deliver gas or electricity for which the swap contract is a hedge.

(F) *Remedial action*. Issuers may apply principles similar to the rules of § 1.141–12, including § 1.141–12(d) (relating to redemption or defeasance of nonqualified bonds) and § 1.141–12(e) (relating to alternative use of disposition proceeds), to cure a violation of paragraph (e)(2)(iii)(A)(*2*) or (e)(2)(iii)(B)(*2*) of this section. For this purpose, the amount of nonqualified bonds is determined in the same manner as for output contracts taken into account under the private business tests, including the principles of § 1.141–7(d), treating nonqualified sales of gas or electricity under this paragraph (e)(2)(iii) as satisfying the benefits and burdens test under § 1.141–7(c)(1).

(iv) *Additional prepayments as permitted by the Commissioner.* The Commissioner may, by published guidance, set forth additional circumstances in which a prepayment does not give rise to investment-type property.

* * * * *

Par. 7. Section 1.148–11 is amended by adding paragraph (j) to read as follows:

§ 1.148–11 Effective dates.

* * * * *

(j) *Certain prepayments.* Section 1.148–1(e)(1) and (2) apply to bonds sold on or after October 3, 2003. Issuers may apply § 1.148–1(e)(1) and (2), in whole but not in part, to bonds sold before October 3, 2003 that are subject to § 1.148–1.

Dale F. Hart,

Acting Deputy Commissioner for Services and Enforcement.

Approved: July 25, 2003.

Pamela F. Olson,

Assistant Secretary of the Treasury.

[FR Doc. 03–19644 Filed 8–1–03; 8:45 am]

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DEPARTMENT OF THE TREASURY

Office of Foreign Assets Control

31 CFR Parts 591 and 592

Rough Diamonds (Sierra Leone & Liberia) Sanctions Regulations; Rough Diamonds Control Regulations

AGENCY: Office of Foreign Assets Control, Treasury.

ACTION: Interim final rule.

SUMMARY: The Office of Foreign Assets Control of the U.S. Department of the Treasury is amending and issuing regulations to carry out the purposes of Executive Order 13312 of July 29, 2003, which implemented the Clean Diamond Trade Act and the Kimberley Process Certification Scheme for rough diamonds and amended prior Executive orders that served as the bases for restricting or prohibiting the importation into the United States of rough diamonds from Sierra Leone or Liberia.

DATES: *Effective Date:* July 30, 2003.

Comments: Written comments must be received no later than October 3, 2003.

ADDRESSES: Comments may be submitted to the Chief of Records, ATTN: Request for Comments, Office of Foreign Assets Control, Department of the Treasury, 1500 Pennsylvania Avenue, NW., Washington, DC 20220. Alternatively, comments may be submitted via facsimile to the Chief of Records at 202/622–1657 or via OFAC's Web site (*http://www.treas.gov/offices/enforcement/ofac/comment.html*).

FOR FURTHER INFORMATION CONTACT: OFAC's Chief of Policy Planning and Program Management, tel.: 202/622–2500, or Chief Counsel, tel.: 202/622–2410.

SUPPLEMENTARY INFORMATION:

Electronic and Facsimile Availability

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Background

On July 29, 2003, the President issued Executive Order 13312, taking into account enactment of the Clean Diamond Trade Act (Pub. L. 108–19), which implements the multilateral Kimberley Process Certification Scheme for rough diamonds (KPCS), and recent developments in Sierra Leone and Liberia. The Clean Diamond Trade Act requires the President, subject to certain waiver authorities, to prohibit the importation into, and exportation from, the United States of any rough diamond not controlled through the KPCS. This means shipments of rough diamonds between the United States and non-Participants in the KPCS generally are prohibited, and shipments between the United States and Participants are permitted only if they are handled in accordance with the standards, practices, and procedures of the KPCS set out in these regulations. Executive Order 13312 implemented the Clean Diamond Trade Act and the KPCS and amended Executive Orders 13194 and 13213, which are described below.

On January 18, 2001, the President issued Executive Order 13194 (66 FR 7389, Jan. 23, 2001), taking into account United Nations Security Council Resolution (UNSCR) 1306 of July 5, 2000. This order declared a national emergency in response to the role played by the illicit trade in diamonds in fueling conflict and human rights violations in Sierra Leone (RUF) and prohibited the importation into the United States of rough diamonds from Sierra Leone that were not controlled by the Government of Sierra Leone through its Certificate of Origin regime.

On May 22, 2001, the President issued Executive Order 13213 (66 FR 28829, May 24, 2001), taking into account UNSCR 1343 of March 7, 2001. This order expanded the scope of the national emergency declared in Executive Order 13194 to respond to, among other things, the Government of Liberia's complicity in the illicit trade in rough diamonds through Liberia. Executive Order 13213 prohibited the direct or indirect importation into the United States of all rough diamonds from Liberia, whether or not such diamonds originated in Liberia.

The United Nations Security Council decided to allow the ban against the importation of rough diamonds from Sierra Leone without a certificate of origin to expire on June 4, 2003, taking into account the Government of Sierra Leone's increased efforts to control and manage its diamond industry and ensure proper control over diamond mining areas, as well as the Government's full participation in the KPCS. In addition, however, on May 6, 2003, the Security Council renewed for one year the absolute import ban on rough diamonds from Liberia based on evidence that the Government of Liberia continues to breach the measures imposed by UNSCR 1343 (2001).

Executive Order 13312 authorized the Secretary of the Treasury to promulgate rules and regulations as may be necessary to carry out the purposes of the order. To implement the order, the Office of Foreign Assets Control, acting pursuant to delegated authority, is issuing the Rough Diamonds Control Regulations and revising the Rough Diamonds (Sierra Leone & Liberia) Sanctions Regulations.

Amendments to Part 591—Rough Diamonds (Sierra Leone & Liberia) Sanctions Regulations

Section 591.201 of subpart B of the regulations, prohibiting the importation of rough diamonds from Sierra Leone and Liberia, is revised to implement section 3 of Executive Order 13312, which amended Executive Order 13194 to control rough diamonds from Sierra Leone through the KPCS and also amended Executive Order 13213 to remove licensing and other authorities with respect to rough diamonds from Liberia. As revised, the prohibition in § 591.201 is limited in scope to rough diamonds from Liberia and is not subject to possible licensing or other administrative action. A note is added to § 591.201 to refer the reader to new part 592, which now controls the importation into, and the exportation from, the United States of rough diamonds from Sierra Leone and other countries.

Section 591.301 of subpart C is removed to reflect the removal of Sierra Leonean rough diamonds from the scope of part 591 and the replacement of the certificate of origin regime of the Government of Sierra Leone with the KPCS in new part 592. Section 591.302, defining the term effective date, is revised to delete the reference to Sierra Leone. Section 591.306 is revised to reflect the KPCS definition of the term rough diamond. Section 591.308 is revised to delete the references to Sierra Leone in the term rough diamonds from Sierra Leone and Liberia. Section 591.309 is revised to conform the definition of the term ''United States'' to section 3(10) of the Clean Diamond Trade Act.

Section 591.404 of subpart D, relating to the transshipment or transit of rough diamonds through the United States, is revised to delete the reference to rough diamonds from Sierra Leone. Sections 591.405 and 591.406, relating to the direct or indirect importation of rough diamonds and the importation into and release from a bonded warehouse or foreign trade zone of rough diamonds are revised to delete the references to Sierra Leone.

New Part 592—Rough Diamonds Control Regulations

Section 592.201(a) of subpart B of the regulations implements section 1(a) of Executive Order 13312, which implements section 4(a) of the Clean Diamond Trade Act and the KPCS. Section 592.201(a) prohibits, subject to possible exceptions described below, the importation into, or exportation from, the United States of any rough diamond, from whatever source, on or after July 30, 2003, unless the rough diamond is controlled through the KPCS. Section 592.201(b) implements section 4(b) of the Clean Diamond Trade Act by excepting from the prohibitions of § 592.201(a) importations from, or exportations to, any country with respect to which the Secretary of State has waived the prohibitions pursuant to section 4(b) of the Clean Diamond Trade Act and section 2(a)(i) of Executive Order 13312.

Section 592.202 implements section 1(b) of Executive Order 13312 by prohibiting any transaction by a United States person or within the United States that evades or avoids, or has the purpose of evading or avoiding, or attempts to violate, any of the prohibitions set forth in section 1 of the order. Section 592.202 also implements section 1(c) of the order by prohibiting any conspiracy formed to violate any of the prohibitions of the order.

Subpart C of part 592 provides definitions of terms used in the regulations, including exporting authority, importing authority, Kimberley Process Certificate, Kimberley Process Certification Scheme, and rough diamond. Subpart D sets forth interpretive guidance with respect to the regulations. For example, §§ 592.403 and 592.404 provide guidance with respect to the transshipment or transit through the United States of rough diamonds and the importation into and release of rough diamonds from a bonded warehouse or foreign trade zone, respectively.

Subpart E of part 592 sets forth provisions relating to required records and reports. Penalties for violations of the regulations are described in subpart F of the regulations.

Request for Comments; Procedural Requirements

Because the regulations involve a foreign affairs function, the provisions of Executive Order 12866 and the Administrative Procedure Act (5 U.S.C. 553) (the ''APA'') requiring notice of proposed rulemaking, opportunity for public participation, and delay in effective date are inapplicable. However, because of the importance of the issues addressed in these regulations, this rule is being issued in interim form and comments will be considered in the development of final regulations. Accordingly, the Department encourages interested persons who wish to comment to do so at the earliest possible time to permit the fullest consideration of their views. Comments may address the impact of the regulations on the submitter's activities, whether of a commercial, non-commercial or humanitarian nature, as well as changes that would improve the clarity and organization of the regulations.

The period for submission of comments will close October 3, 2003. The Department will consider all comments received before the close of the comment period in developing final regulations. Comments received after the end of the comment period will be considered if possible, but their consideration cannot be assured. The Department will not accept public comments accompanied by a request that a part or all of the submission be treated confidentially because of its business proprietary nature or for any other reason. The Department will return any such submission to the originator without considering it in the development of final regulations. In the interest of accuracy and completeness, the Department requires comments in written form.

All public comments on these regulations will be a matter of public record. Copies of the public record concerning these regulations will be made available not sooner than November 3, 2003 and will be obtainable from OFAC's Web site (*http://www.treas.gov/ofac*). If that service is unavailable, written requests for copies may be sent to: Office of Foreign Assets Control, U.S. Department of the Treasury, 1500 Pennsylvania Ave., NW, Washington, DC 20220, Attn: Chief of Records Division.

Because no notice of proposed rulemaking is required for this rule, the Regulatory Flexibility Act (5 U.S.C. 601–612) does not apply.

Paperwork Reduction Act

The collections of information related to the regulations are contained in 31 CFR part 501 (the ''Reporting and Procedures Regulations''). Pursuant to the Paperwork Reduction Act of 1995 (44 U.S.C. 3507), those collections of information have been previously approved by the Office of Management and Budget under control number 1505–0164. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

List of Subjects

31 CFR Part 591

Administrative practice and procedure, Blocking, Certificate of origin, Conflict diamonds, Diamonds, Exports, Exporting authority, Foreign trade, Importing authority, Imports, Kimberley Process, Liberia, Penalties, Reporting and recordkeeping requirements, Rough diamonds, Sierra Leone.

31 CFR Part 592

Administrative practice and procedure, Foreign trade, Exports, Imports, Kimberley Process, Penalties, Reporting and recordkeeping requirements, Rough diamond.

■ For the reasons set forth in the preamble, 31 CFR chapter V, part 591 is amended and part 592 is added as follows:

■ 1. The title for part 591 is revised to read as follows:

PART 591—ROUGH DIAMONDS (LIBERIA) SANCTIONS REGULATIONS

■ 2. The authority citation for part 591 is revised to read as follows:

Authority: 3 U.S.C. 301; 31 U.S.C. 321(b); 22 U.S.C. 287c; 50 U.S.C. 1601–1641, 1701–1706; Pub. L. 101–410, 104 Stat. 890 (28 U.S.C. 2461 note); E.O. 13194, 66 FR 7389 (January 23, 2001); E.O. 13213, 66 FR 28829 (May 24, 2001); E.O. 13312 (FR vol. 68, no. 147, July 31, 2003).

Subpart B—Prohibitions

■ 3. Section 591.201 is revised to read as follows:

§ 591.201 Prohibited importation of any rough diamond.

Notwithstanding the existence of any rights or obligations conferred or imposed by any contract entered into or any license or permit granted prior to the effective date, the direct or indirect importation into the United States, on or after the effective date, of any rough diamond from Liberia is prohibited.

Note to § 591.201. *See* part 592 of this chapter for additional regulations controlling the importation into the United States of any rough diamond from any country other than Liberia, as well as the exportation from the United States of any rough diamond from any source.

§ 591.202 [Removed and reserved]

■ 4. Section 591.202 is removed and reserved.

Subpart C—General Definitions

§ 591.301 [Removed and reserved]

■ 5. Section 591.301 is removed and reserved.

■ 6. Section 591.302 is revised to read as follows:

§ 591.302 Effective date.

The term *effective date* refers to the effective date of the applicable prohibitions and directives contained in this part, which is 12:01 a.m., eastern daylight time, May 23, 2001.

■ 7. Section 591.307 is revised to read as follows:

§ 591.307 Rough diamond.

The term *rough diamond* means any diamond that is unworked or simply sawn, cleaved, or bruted, and classifiable under subheading 7102.10, 7102.21, or 7102.31 of the Harmonized Tariff Schedule of the United States.

■ 8. Section 591.308 is revised to read as follows:

§ 591.308 Rough diamond from Liberia.

The term *rough diamond from Liberia* means any rough diamond extracted in Liberia and any rough diamond that has physically entered the territory of Liberia, regardless of where it had been extracted.

Subpart D—Interpretations

■ 9. Section 591.404 is revised to read as follows:

§ 591.404 Transshipment or transit through the United States prohibited.

The prohibition in § 591.201 applies to the importation into the United States, for transshipment or transit, of any rough diamond from Liberia that is intended or destined for any country other than the United States.

■ 10. Section 591.405 is revised to read as follows:

§ 591.405 Direct or indirect importation of any rough diamond from Liberia.

The prohibition in § 591.201 applies to the importation of any rough diamond from Liberia whether the rough diamond is being imported directly into the United States from Liberia, or indirectly through any other country.

■ 11. Section 591.406 is revised to read as follows:

§ 591.406 Importation into or release of any rough diamond from a bonded warehouse or foreign trade zone.

The prohibition in § 591.201 applies to the importation into or release of any rough diamond from a bonded warehouse or foreign trade zone of the United States. However, § 591.201 does not prohibit the release from a bonded warehouse or a foreign trade zone of any rough diamond from Liberia that was imported into the bonded warehouse or foreign trade zone prior to the effective date.

■ 12. Part 592 is added to 31 CFR Chapter V to read as follows:

PART 592—ROUGH DIAMONDS CONTROL REGULATIONS

Authority: 3 U.S.C. 301; 31 U.S.C. 321(b); 22 U.S.C. 287c; 50 U.S.C. 1601–1641, 1701–1706; Pub. L. 101–410, 104 Stat. 890 (28 U.S.C. 2461 note); Pub. L. 108–19; E.O. 12865, 58 FR 51005, 3 CFR, 1993 Comp., p. 636; E.O. 13098, 63 FR 44771, 3 CFR, 1998 Comp., p. 206; E.O. 13194, 66 FR 7389 (January 23, 2001); E.O. 13213, 66 FR 28829 (May 24, 2001); E.O. 13312 (FR vol. 68, no. 147, July 31, 2003).

Subpart A—Relation of This Part to Other Laws and Regulations

§ 592.101 Relation of this part to other laws and regulations.

This part is separate from, and independent of, the other parts of this chapter, with the exception of part 501 of this chapter, the recordkeeping and reporting requirements and procedures of which apply to this part. Actions taken pursuant to part 501 of this chapter with respect to the prohibitions contained in this part are considered actions taken pursuant to this part. Differing foreign policy and national security circumstances may result in differing interpretations of similar language among the parts of this chapter. No license or authorization contained in or issued pursuant to those other parts authorizes any transaction prohibited by this part. No license or authorization contained in or issued pursuant to any other provision of law or regulation authorizes any transaction prohibited by this part.

Subpart B—Prohibitions

§ 592.201 Prohibited importation and exportation of any rough diamond; permitted importation or exportation of any rough diamond.

(a) Except to the extent provided in paragraph (b) of this section, and notwithstanding the existence of any rights or obligations conferred or imposed by any contract entered into or any license or permit granted prior to the effective date, the importation into, or exportation from, the United States on or after July 30, 2003, of any rough diamond, from whatever source, is prohibited, unless the rough diamond has been controlled through the Kimberley Process Certification Scheme.

(b) The prohibitions in paragraph (a) of this section regarding the importation into, or exportation from, the United States of any rough diamond not controlled through the Kimberley Process Certification Scheme do not apply to an importation from, or exportation to, any country with respect to which the Secretary of State has granted a waiver pursuant to section 4(b) of the Clean Diamond Trade Act (Pub. L. 108–19) and section 2(a)(1) of Executive Order 13312.

Note to § 592.201. An importation of any rough diamond from, or an exportation of any rough diamond to, a non-Participant is not controlled through the Kimberley Process Certification Scheme and thus is not permitted except in the following circumstance. The Secretary of State may, pursuant to section 4(b) of the Clean Diamond Trade Act, waive the prohibitions contained in section 4(a) of that Act with respect to a particular country for periods of not more than one year each. The Secretary of State will publish a notice in the **Federal Register** identifying any country with respect to which a waiver applies and specifying the relevant time period during which the waiver will apply.

§ 592.202 Evasions; attempts; conspiracies.

(a) Notwithstanding the existence of any rights or obligations conferred or imposed by any contract entered into or any license or permit granted prior to July 30, 2003, any transaction by a United States person anywhere, or any transaction that occurs in whole or in part within the United States, on or after the effective date that evades or avoids, or has the purpose of evading or avoiding, or attempts to violate, any of the prohibitions set forth in this part is prohibited.

(b) Notwithstanding the existence of any rights or obligations conferred or imposed by any contract entered into or any license or permit granted prior to July 30, 2003, any conspiracy formed to violate any of the prohibitions of this part is prohibited.

Subpart C—General Definitions

§ 592.301 Controlled through the Kimberley Process Certification Scheme.

(a) Except as otherwise provided in paragraph (b) of this section, the term *controlled through the Kimberley Process Certification Scheme* refers to the following requirements that apply, as appropriate, to the importation into the United States from a Participant, or the exportation from the United States to a Participant, of any shipment including any rough diamond:

(1) *Kimberley Process Certificate.* A shipment of rough diamonds imported into, or exported from, the United States must be accompanied by a Kimberley Process Certificate. The certificate must be presented in connection with an importation or exportation of rough diamonds if demanded by Customs officials.

(2) *Tamper-Resistant Container.* A shipment of rough diamonds imported into, or exported, from the United States must be sealed in a tamper-resistant container;

(3) *Notification Requirements for Importations into the United States.* The importer of record in the United States must confirm receipt of a shipment of rough diamonds to the relevant foreign exporting authority. The confirmation must refer to the relevant Kimberley Process Certificate by serial number, the number of parcels, the carat weight, and the details of the importer and exporter; and

(4) *Validation of Kimberley Process Certificate for Exportations from the United States.* With respect to the exportation of rough diamonds from the United States and regardless of the destination, the Census Bureau requires the filing of export information through the Automated Export System. Submission of export information through the Automated Export System must be done in advance and must be confirmed by the return of an Internal Transaction Number. The return to the filer of the Internal Transaction Number shall constitute the validation of the Kimberley Process Certificate for an exportation of rough diamonds from the United States to a Participant. The exporter is required to report the Internal Transaction Number on the Kimberley Process Certificate accompanying any exportation from the United States. The Internal Transaction Number is a unique confirmation number generated by the Automated Export System to the filer who provides in a timely manner the complete commodity shipment data when such data have been accepted by the system.

(b) The Secretary of State, consistent with section 3(2)(b) of the Clean Diamond Trade Act (Pub. L. 108–19), may modify the requirements set forth in paragraph (a) of this section upon making a determination that a Participant has established an alternative system of control for rough diamonds that meets substantially the standards, practices, and procedures of the Kimberley Process Certification Scheme.

Note 1 to § 592.301. The Secretary of State will periodically publish in the **Federal Register** an up-to-date listing of all Participants. Where appropriate, such listing also will describe any modification of the requirements set forth in paragraph (a) of this section.

Note 2 to § 592.301. The recordkeeping and reporting requirements imposed by § 592.501 apply to all U.S. persons engaged in the importation into, or exportation from, the United States of any shipment of rough diamonds.

§ 592.302 Effective date.

The term *effective date* refers to the effective date of the applicable prohibitions and directives contained in this part, which is 12:01 a.m., eastern daylight time, July 30, 2003.

§ 592.303 Entity.

The term *entity* means a partnership, association, trust, joint venture, corporation, or other organization.

§ 592.304 Exporting authority.

(a) The term *exporting authority* means one or more entities designated by a Participant from whose territory a shipment of rough diamonds is being exported as having the authority to validate the Kimberley Process Certificate.

(b) The exporting authority for the United States is the Bureau of the Census.

Note to § 592.304. The Secretary of State will periodically publish in the **Federal Register** an up-to-date listing of the exporting authorities of all Participants.

§ 592.305 Importation into the United States.

The term *importation into the United States* means the bringing of goods into the United States.

§ 592.306 Importing authority.

(a) The term *importing authority* means one or more entities designated by a Participant into whose territory a shipment of rough diamonds is being imported as having the authority to enforce the laws and regulations of the Participant regulating imports, including the verification of the Kimberley Process Certificate accompanying the shipment.

(b) The importing authorities for the United States are the United States Bureau of Customs and Border Protection or, in the case of a territory or possession of the United States with its own customs administration, analogous officials.

Note to § 592.306. The Secretary of State will periodically publish in the **Federal Register** an up-to-date listing of the importing authorities of all Participants.

§ 592.307 Kimberley Process Certificate.

The term *Kimberley Process Certificate* means a tamper- and forgery-resistant document that bears the following information in any language, provided that an English translation is incorporated:

(a) The title ''Kimberley Process Certificate'' and the statement: ''The rough diamonds in this shipment have been handled in accordance with the provisions of the Kimberley Process Certification Scheme for rough diamonds'';

(b) Country of origin for shipment of parcels of unmixed (*i.e.*, from the same) origin;

(c) Unique numbering with the Alpha 2 country code, according to ISO 3166–1;

(d) Date of issuance;

(e) Date of expiry;

(f) Name of issuing authority;

(g) Identification of exporter and importer;

(h) Carat weight/mass;

(i) Value in U.S. dollars;

(j) Number of parcels in the shipment;

(k) Relevant Harmonized Commodity Description and Coding System; and

(l) Validation by the exporting authority.

Note to § 592.307. *See* § 592.301(a)(4) for procedures governing the validation of the Kimberley Process Certificate when exporting from the United States.

§ 592.308 Participant.

The term *Participant* means a state, customs territory, or regional economic integration organization identified by the Secretary of State as one for which rough diamonds are controlled through the Kimberley Process Certification Scheme.

Note to § 592.308. The Secretary of State will periodically publish in the **Federal Register** an up-to-date listing of all Participants.

§ 592.309 Person.

The term *person* means an individual or entity.

§ 592.310 Rough diamond.

The term *rough diamond* means any diamond that is unworked or simply sawn, cleaved, or bruted and classifiable under subheading 7102.10, 7102.21, or 7102.31 of the Harmonized Tariff Schedule of the United States.

§ 592.311 United States.

The term *United States*, when used in the geographic sense, means the several States, the District of Columbia, and any commonwealth, territory, or possession of the United States.

§ 592.312 United States person; U.S. person.

The term *United States person* or *U.S. person* means any United States citizen; any alien admitted for permanent residence into the United States; any entity organized under the laws of the United States or any jurisdiction within the United States (including its foreign branches); or any person in the United States.

Subpart D—Interpretations

§ 592.401 Reference to amended sections.

Except as otherwise specified, reference to any provision in this part or chapter or to any other regulation refers to the same as currently amended.

§ 592.402 Effect of amendment.

Unless otherwise specifically provided, any amendment, modification, or revocation of any provision in or appendix to this part or chapter or of any order, regulation, ruling, or instruction issued by or under the direction of the Director of the Office of Foreign Assets Control does not affect any act done or omitted, or any civil or criminal suit or proceeding commenced or pending prior to such amendment, modification, or revocation. All penalties, forfeitures, and liabilities under any such order, regulation, ruling, or instruction continue and may be enforced as if such amendment, modification, or revocation had not been made.

§ 592.403 Transshipment or transit through the United States.

The prohibitions in § 592.201 apply to the importation into, or exportation from, the United States, for transshipment or transit, of any rough diamond intended or destined for any country other than the United States unless the shipment is sealed in a tamper-resistant container, accompanied by a Kimberley Process Certificate, and leaves the United States in an identical state as it entered. The validation, recordkeeping, and confirmation procedures applicable to importations and exportations do not apply in this case.

§ 592.404 Importation into or release from a bonded warehouse or foreign trade zone.

The requirements of the Kimberley Process Certification Scheme apply to all imported shipments of a rough diamond, regardless of whether they are destined for entry into, or withdrawal from, a bonded warehouse or a foreign trade zone of the United States.

Subpart E—Records and Reports

§ 592.501 Records and reports.

(a) Any United States person seeking to export from or import into the United States any rough diamond shall keep a full record of, in the form of reports or otherwise, complete information relating to any act or transaction to which any prohibition imposed under § 592.201(a) applies. Such record shall be available for examination for at least 5 years after the date of such act or transaction.

(b) Every United States person is required to furnish under oath, in the form of reports or otherwise, from time to time and at any time as may be required by the Director, Office of Foreign Assets Control, complete information relative to any act or transaction subject to the provisions of this part. The Director may require that such reports include the production of books of account, records, contracts, letters, memoranda, or other papers in the custody or control of persons required to make such reports. Reports with respect to any acts or transactions may be required either before or after such acts or transactions are completed.

Subpart F—Penalties

§ 592.601 Penalties.

(a) Attention is directed to section 8 of the Clean Diamond Trade Act (the ''Act'') (Pub. L. 108–19), which provides that:

(1) A civil penalty not to exceed $10,000 per violation may be imposed on any person who violates, or attempts to violate, any order or regulation issued under the Act;

(2) Whoever willfully violates, or willfully attempts to violate, any order or regulation issued under this Act shall, upon conviction, be fined not more than $50,000, or, if a natural person, may be imprisoned for not more than 10 years, or both; and any officer, director, or agent of any corporation who willfully participates in such violation may be punished by a like fine, imprisonment, or both; and

(3) Those customs laws of the United States, both civil and criminal, including those laws relating to seizure and forfeiture, that apply to articles imported in violation of such laws shall apply with respect to any rough diamond imported in violation of the Act.

Note to paragraph (a). As reflected in paragraphs (a)(1) and (2) above, section 8(a) of the Clean Diamond Trade Act (Pub. L. 108–19) establishes penalties with respect to any violation of any regulation issued under the Act. OFAC prepenalty, penalty, and administrative collection procedures relating to such violations are set forth below in §§ 592.602 through 592.605. Section 8(c) of the Act also authorizes the United States Bureau of Customs and Border Protection and the United States Bureau of Immigration and Customs Enforcement, as appropriate, to enforce the penalty provisions set forth in paragraph (a) and to enforce the laws and regulations governing exports of rough diamonds, including with respect to the validation of the Kimberley Process Certificate by the Bureau of the Census. The OFAC civil penalty procedures set forth below are separate from, and independent of, any penalty procedures that may be followed by the United States Bureau of Customs and Border Protection and the United States Bureau of Immigration and Customs Enforcement in their exercise of the authorities set forth in section 8(c) of the Clean Diamond Trade Act.

(b) The criminal penalties provided in the Act are subject to increase pursuant to 18 U.S.C. 3571.

(c) Attention is also directed to 18 U.S.C. 1001, which provides that whoever, in any matter within the jurisdiction of the executive, legislative, or judicial branch of the Government of the United States, knowingly and willfully falsifies, conceals, or covers up by any trick, scheme, or device, a material fact, or makes any materially false, fictitious, or fraudulent statement or representation or makes or uses any false writing or document knowing the same to contain any materially false, fictitious, or fraudulent statement or entry shall be fined under title 18, United States Code, or imprisoned not more than five years, or both.

(d) Violations of this part may also be subject to relevant provisions of other applicable laws.

§ 592.602 Prepenalty notice.

(a) *When required.* If the Director of the Office of Foreign Assets Control has reasonable cause to believe that there has occurred a violation of any provision of this part or a violation of the provisions of any regulation or order issued by or pursuant to the direction or authorization of the Secretary of the Treasury pursuant to this part or otherwise under the Clean Diamond Trade Act, and the Director determines that further proceedings are warranted, the Director shall notify the alleged violator of the agency's intent to impose a monetary penalty by issuing a prepenalty notice. The prepenalty notice shall be in writing. The prepenalty notice may be issued whether or not another agency has taken any action with respect to the matter.

(b) *Contents of notice*—(1) *Facts of violation.* The prepenalty notice shall describe the violation, specify the laws and regulations allegedly violated, and state the amount of the proposed monetary penalty.

(2) *Right to respond.* The prepenalty notice also shall inform the respondent of the respondent's right to make a written presentation within the applicable 30-day period set forth in § 592.703 as to why a monetary penalty should not be imposed or why, if imposed, the monetary penalty should be in a lesser amount than proposed.

(c) *Informal settlement prior to issuance of prepenalty notice.* At any time prior to the issuance of a prepenalty notice, an alleged violator may request in writing that, for a period not to exceed sixty (60) days, the agency withhold issuance of the prepenalty notice for the exclusive purpose of effecting settlement of the agency's potential civil monetary penalty claims. In the event the Director grants the request, under terms and conditions within his discretion, the Office of Foreign Assets Control will agree to withhold issuance of the prepenalty notice for a period not to exceed 60 days and will enter into settlement negotiations of the potential civil monetary penalty claim.

§ 592.603 Response to prepenalty notice; informal settlement.

(a) *Deadline for response.* The respondent may submit a response to the prepenalty notice within the applicable 30-day period set forth in this paragraph. The Director may grant, at his discretion, an extension of time in which to submit a response to the prepenalty notice. The failure to submit a response within the applicable time period set forth in this paragraph shall be deemed to be a waiver of the right to respond.

(1) *Computation of time for response.* A response to the prepenalty notice must be postmarked or date-stamped by the U.S. Postal Service (or foreign postal service, if mailed abroad) or courier service provider (if transmitted to OFAC by courier) on or before the 30th day after the postmark date on the envelope in which the prepenalty notice was mailed. If the respondent refused delivery or otherwise avoided receipt of the prepenalty notice, a response must be postmarked or date-stamped on or before the 30th day after the date on the stamped postal receipt maintained at the Office of Foreign Assets Control. If the prepenalty notice was personally delivered to the respondent by a non-U.S. Postal Service agent authorized by the Director, a response must be postmarked or date-stamped on or before the 30th day after the date of delivery.

(2) *Extensions of time for response.* If a due date falls on a federal holiday or weekend, that due date is extended to include the following business day. Any other extensions of time will be granted, at the Director's discretion, only upon the respondent's specific request to the Office of Foreign Assets Control.

(b) *Form and method of response.* The response must be submitted in typewritten form and signed by the respondent or a representative thereof. The response need not be in any particular form. A copy of the response may be sent by facsimile, but the original also must be sent to the Office of Foreign Assets Control Civil Penalties Division by mail or courier and must be postmarked or date-stamped, in accordance with paragraph (a) of this section.

(c) *Contents of response.* A written response must contain information sufficient to indicate that it is in response to the prepenalty notice and must identify the Office of Foreign Assets Control identification number listed on the prepenalty notice.

(1) A written response must include the respondent's full name, address, telephone number, and facsimile

number, if available, or those of the representative of the respondent.

(2) A written response should either admit or deny each specific violation alleged in the prepenalty notice and also state if the respondent has no knowledge of a particular violation. If the written response fails to address any specific violation alleged in the prepenalty notice, that alleged violation shall be deemed to be admitted.

(3) A written response should include any information in defense, evidence in support of an asserted defense, or other factors that the respondent requests the Office of Foreign Assets Control to consider. Any defense or explanation previously made to the Office of Foreign Assets Control or any other agency must be repeated in the written response. Any defense not raised in the written response will be considered waived. The written response also should set forth the reasons why the respondent believes the penalty should not be imposed or why, if imposed, it should be in a lesser amount than proposed.

(d) *Failure to respond.* Where OFAC receives no response to a prepenalty notice within the applicable time period set forth in paragraph (a) of this section, a penalty notice generally will be issued, taking into account the mitigating and/or aggravating factors present in the record. If there are no mitigating factors present in the record, or the record contains a preponderance of aggravating factors, the proposed prepenalty amount generally will be assessed as the final penalty.

(e) *Informal settlement.* In addition to or as an alternative to a written response to a prepenalty notice, the respondent or respondent's representative may contact the Office of Foreign Assets Control as advised in the prepenalty notice to propose the settlement of allegations contained in the prepenalty notice and related matters. However, the requirements set forth in paragraph (f) of this section as to oral communication by the representative must first be fulfilled. In the event of settlement at the prepenalty stage, the claim proposed in the prepenalty notice will be withdrawn, the respondent will not be required to take a written position on allegations contained in the prepenalty notice, and the Office of Foreign Assets Control will make no final determination as to whether a violation occurred. The amount accepted in settlement of allegations in a prepenalty notice may vary from the civil penalty that might finally be imposed in the event of a formal determination of violation. In the event no settlement is reached, the time limit specified in paragraph (a) of this section for written response to the prepenalty notice will remain in effect unless additional time is granted by the Office of Foreign Assets Control.

(f) *Representation.* A representative of the respondent may act on behalf of the respondent, but any oral communication with the Office of Foreign Assets Control prior to a written submission regarding the specific allegations contained in the prepenalty notice must be preceded by a written letter of representation, unless the prepenalty notice was served upon the respondent in care of the representative.

§ 592.604 Penalty imposition or withdrawal.

(a) *No violation.* If, after considering any response to the prepenalty notice and any relevant facts, the Director of the Office of Foreign Assets Control determines that there was no violation by the respondent named in the prepenalty notice, the Director shall notify the respondent in writing of that determination and of the cancellation of the proposed monetary penalty.

(b) *Violation.* (1) If, after considering any written response to the prepenalty notice, or default in the submission of a written response, and any relevant facts, the Director of the Office of Foreign Assets Control determines that there was a violation by the respondent named in the prepenalty notice, the Director is authorized to issue a written penalty notice to the respondent of the determination of the violation and the imposition of the monetary penalty.

(2) The penalty notice shall inform the respondent that payment or arrangement for installment payment of the assessed penalty must be made within 30 days of the date of mailing of the penalty notice by the Office of Foreign Assets Control.

(3) The penalty notice shall inform the respondent of the requirement to furnish the respondent's taxpayer identification number pursuant to 31 U.S.C. 7701 and that such number will be used for purposes of collecting and reporting on any delinquent penalty amount.

(4) The issuance of the penalty notice finding a violation and imposing a monetary penalty shall constitute final agency action. The respondent has the right to seek judicial review of that final agency action in federal district court.

§ 592.605 Administrative collection; referral to United States Department of Justice.

In the event that the respondent does not pay the penalty imposed pursuant to this part or make payment arrangements acceptable to the Director of the Office of Foreign Assets Control within 30 days of the date of mailing of the penalty notice, the matter may be referred for administrative collection measures by the Department of the Treasury or to the United States Department of Justice for appropriate action to recover the penalty in a civil suit in a federal district court.

Subpart G—Procedures

§ 592.701 Procedures.

For procedures relating to rulemaking and requests for documents pursuant to the Freedom of Information and Privacy Acts (5 U.S.C. 552 and 552a), *see* part 501, subpart E, of this chapter.

§ 592.702 Delegation by the Secretary of the Treasury.

Any action that the Secretary of the Treasury is authorized to take pursuant to Executive Order 13312 (FR vol. 68, No. 147, July 31, 2003) and any further Executive orders relating to the Clean Diamond Trade Act (Pub. L. 108–19) may be taken by the Director of the Office of Foreign Assets Control or by any other person to whom the Secretary of the Treasury has delegated authority so to act.

Subpart H—Paperwork Reduction Act

§ 592.801 Paperwork Reduction Act notice.

For approval by the Office of Management and Budget (''OMB'') under the Paperwork Reduction Act of 1995 (44 U.S.C. 3507) of information collections relating to recordkeeping and reporting requirements and other procedures, *see* § 501.901 of this chapter. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by OMB.

Dated: July 30, 2003.

R. Richard Newcomb,

Director, Office of Foreign Assets Control.

Approved: July 30, 2003.

Juan C. Zarate,

Deputy Assistant Secretary (Terrorist Financing and Financial Crimes), Department of the Treasury.

[FR Doc. 03–19821 Filed 7–30–03; 4:19 pm]

BILLING CODE 4810–25–P

DEPARTMENT OF HOMELAND SECURITY

Coast Guard

33 CFR Part 117

[CGD07–03–129]

RIN 1625–AA09

Drawbridge Operation Regulations; Atlantic Intracoastal Waterway, Mile 1060.5 at Fort Lauderdale, Broward County, FL

AGENCY: Coast Guard, DHS.

ACTION: Temporary final rule.

SUMMARY: The Coast Guard is temporarily changing the regulations governing the operation of the Oakland Park Boulevard Bridge, mile 1060.5, Fort Lauderdale, Florida. Under this temporary rule, the Bridge need open only twice an hour. This temporary rule is required to allow the bridge owner to provide for worker safety while completing repairs to the bridge.

DATES: This rule is effective from 6 a.m. on July 28, 2003, to 8 p.m. on October 31, 2003.

ADDRESSES: Documents indicated in this preamble as being available in the docket are part of docket CGD07–03–129 and are available for inspection or copying at Commander (obr), Seventh Coast Guard District, 909 S.E. 1st Avenue, Room 432, Miami, FL 33131, between 7:30 a.m. and 4 p.m., Monday through Friday, except Federal holidays.

FOR FURTHER INFORMATION CONTACT: Mr. Michael Lieberum, Project Officer, Seventh Coast Guard District, Bridge Branch, at (305) 415–6744.

SUPPLEMENTARY INFORMATION:

Request for Comments

We encourage you to participate in this rulemaking by submitting comments and related material. If you do so, please include your name and address, identify the docket number for this rulemaking [CGD07–03–129], indicate the specific section of this document to which each comment applies, and give the reason for each comment. Please submit all comments and related material in an unbound format, no larger than 8½ by 11 inches, suitable for copying. If you would like to know they reached us, please enclose a stamped, self-addressed postcard or envelope. We will consider all comments and material received during the comment period.

Regulatory Information

We did not publish a notice of proposed rulemaking (NRPM) for this regulation. Under 5 U.S.C. 553(b)(B), the Coast Guard finds that good cause exists for not publishing an NPRM. Publishing an NPRM was impracticable and contrary to the public interest, because the rule was needed to allow the contractor to provide for worker safety while repairing the bridge. The emergency repair work is required before the winter season when there will be increased boating/vehicular traffic in the area. Also, since the temporary rule provides for regularly scheduled bridge openings, vessel traffic will not be unduly disrupted during the repair process.

Under 5 U.S.C. 553(d)(3), the Coast Guard finds that good cause exists for making this rule effective less than 30 days after **Federal Register** publication. We received a request to change the bridge's operating schedule on June 10, 2003, to effect emergency repair work to the bridge before the busy winter season, and did not have sufficient time remaining to either publish an NPRM or delay the effective date of the rule. This temporary rule provides for scheduled bridge openings so as to allow the contractor to safely repair the bridge without disrupting vessel traffic.

Background and Purpose

The Oakland Park Boulevard Bridge, mile 1060.5 at Fort Lauderdale, Broward County, Florida, has a vertical clearance of 22 feet at mean high water and a horizontal clearance of 88 feet between the fender systems. The existing operating regulations in 33 CFR 117.261 require the bridge to open on signal from May 16 to November 14 and to open at regular intervals during the winter season.

PCL Contractors notified the Coast Guard on June 10, 2003, that work on the bascule leaves is scheduled from July 28, 2003, to October 31, 2003. For safety reasons, they request a 30-minute opening schedule during this repair period. This action is necessary to provide for worker safety during repairs to the bridge and does not significantly hinder navigation, as regularly scheduled openings will be provided.

Discussion of Rule

This temporary rule allows this bridge to open only on the quarter-hour and three-quarter hour from July 28, 2003, to October 31, 2003. This action is necessary for workers' safety during repairs to the bridge and does not significantly hinder navigation.

Regulatory Evaluation

This rule is not a ''significant regulatory action'' under section 3(f) of Executive Order 12866, Regulatory Planning and Review, and does not require an assessment of potential costs and benefits under section 6(a)(3) of that Order. The Office of Management and Budget has not reviewed it under that Order. It is not ''significant'' under the regulatory policies and procedures of the Department of Homeland Security (DHS). The Coast Guard expects the economic impact of this rule to be so minimal that a full Regulatory Evaluation is unnecessary, because the rule will affect only a small percentage of vessel traffic through this bridge, as it is not yet the winter season. The impact on vessel traffic will, at most, be a 30-minute waiting period. Regularly scheduled openings will allow vessel traffic to transit the area.

Small Entities

Under the Regulatory Flexibility Act (5 U.S.C. 601–612), we considered whether this temporary rule would have a significant economic impact on a substantial number of small entities. The term ''small entities'' comprises small businesses, not-for-profit organizations that are independently owned and operated and are not dominant in their fields, and governmental jurisdictions with populations of less than 50,000.

The Coast Guard certifies under 5 U.S.C. 605(b) that this temporary rule would not have a significant economic impact on a substantial number of small entities, because the regulations will affect only a limited amount of marine traffic and will still provide for their navigation needs.

If you think that your business, organization, or governmental jurisdiction qualifies as a small entity and that this temporary rule would have a significant economic impact on it, please submit a comment to the address under **ADDRESSES**. In your comment, explain why you think it qualifies and how and to what degree this rule would economically affect it.

Assistance for Small Entities

Under section 213(a) of the Small Business Regulatory Enforcement Fairness Act of 1996 (Public Law 104–121), we want to assist small entities in understanding this temporary rule so that they can better evaluate its effects on them and participate in the rulemaking. If this temporary rule would affect your small business, organization, or governmental jurisdiction and you have questions concerning its provisions or options for compliance, please contact the person listed in **FOR FURTHER INFORMATION CONTACT**.

Small businesses may send comments on the actions of Federal employees who enforce, or otherwise determine compliance with, Federal regulations to the Small Business and Agriculture Regulatory Enforcement Ombudsman and the Regional Small Business Regulatory Fairness Boards. The Ombudsman evaluates these actions annually and rates each agency's responsiveness to small business. If you wish to comment on actions by employees of the Coast Guard, call 1–888–REG–FAIR (1–888–734–3247).

Collection of Information

This rule calls for no new collection of information under the Paperwork Reduction Act of 1995 (44 U.S.C. 3501–3520).

Federalism

A rule has implications for federalism under Executive Order 13132, Federalism, if it has a substantial direct effect on State or local governments and would either preempt State law or impose a substantial direct cost of compliance on them. We have analyzed this rule under that Order and have determined that it does not have implications for federalism.

Unfunded Mandates Reform Act

The Unfunded Mandates Reform Act of 1995 (2 U.S.C. 1531–1538) requires Federal agencies to assess the effects of their discretionary regulatory actions. In particular, the Act addresses actions that may result in the expenditure by a State, local, or tribal government, in the aggregate, or by the private sector of $100,000,000 or more in any one year. Though this rule would not result in such an expenditure, we do discuss the effects of this rule elsewhere in the preamble.

Taking of Private Property

This rule will not effect a taking of private property or otherwise have taking implications under Executive Order 12630, Governmental Actions and Interference with Constitutionally Protected Property Rights.

Civil Justice Reform

This rule meets applicable standards in sections 3(a) and 3(b)(2) of Executive Order 12988, Civil Justice Reform, to minimize litigation, eliminate ambiguity, and reduce burden.

Protection of Children

We have analyzed this rule under Executive Order 13045, Protection of Children from Environmental Health Risks and Safety Risks. This rule is not an economically significant rule and would not create an environmental risk to health or risk to safety that might disproportionately affect children.

Indian Tribal Governments

This rule does not have tribal implications under Executive Order 13175, Consultation and Coordination with Indian Tribal Governments, because it does not have a substantial direct effect on one or more Indian tribes, on the relationship between the Federal Government and Indian tribes, or on the distribution of power and responsibilities between the Federal Government and Indian tribes.

Energy Effects

We have analyzed this rule under Executive Order 13211, Actions Concerning Regulations That Significantly Affect Energy Supply, Distribution, or Use. We have determined that it is not a ''significant energy action'' under that order, because it is not a ''significant regulatory action'' under Executive Order 12866 and is not likely to have a significant adverse effect on the supply, distribution, or use of energy. The Administrator of the Office of Information and Regulatory Affairs has not designated it as a significant energy action. Therefore, it does not require a statement of Energy Effects under Executive Order 13211.

Environment

We have analyzed this rule under Commandant Instruction M16475.1D, which guides the Coast Guard in complying with the National Environmental Policy Act of 1969 (NEPA) (42 U.S.C. 4321–4370f), and have concluded that there are no factors in this case that would limit the use of a categorical exclusion under section 2.B.2 of the Instruction. Therefore, this rule is categorically excluded, under figure 2–1, paragraph (32)(e), of the Instruction, from further environmental documentation. Under figure 2–1, paragraph (32)(e), of the Instruction, an ''Environmental Analysis Check List'' and a ''Categorical Exclusion Determination'' are not required for this rule.

List of Subjects in 33 CFR Part 117

Bridges.

■ For the reasons discussed in the preamble, the Coast Guard amends 33 CFR part 117 as follows:

PART 117—DRAWBRIDGE OPERATION REGULATIONS

■ 1. The authority citation for part 117 continues to read as follows:

Authority: 33 U.S.C. 499; Department of Homeland Security Delegation No. 0170.1; 33 CFR 1.05–1(g); Section 117.255 also issued under authority of Pub. L. 102–587, 106 Stat. 5039.

■ 2. From 6 a.m. on July 28, 2003, until 8 p.m. on October 31, 2003, § 117.261, paragraph (ff), is suspended and new paragraph (uu) is added to read as follows:

§ 117.261 Atlantic Intracoastal Waterway from St. Marys River to Key Largo.

* * * * *

(uu) The Oakland Park Boulevard Bridge, mile 1060.5 at Fort Lauderdale, need open only on the quarter-hour and three-quarter-hour.

* * * * *

Dated: July 22, 2003.

H.E. Johnson, Jr.,

Rear Admiral, U.S. Coast Guard Commander, Seventh Coast Guard District.

[FR Doc. 03–19543 Filed 8–1–03; 8:45 am]

BILLING CODE 4910–15–P

DEPARTMENT OF HOMELAND SECURITY

Coast Guard

46 CFR Part 188

Harmonization With International Safety Standards

CFR Correction

In Title 46 of the Code of Federal Regulations, Parts 166 to 199, revised as of October 1, 2002, in part 188, on page 342, remove the second § 188.10–45.

[FR Doc. 03–55516 Filed 8–1–03; 8:45 am]

BILLING CODE 1505–01–D

DEPARTMENT OF HOMELAND SECURITY

Coast Guard

46 CFR Part 189

Frequency of Inspection

CFR Correction

In Title 46 of the Code of Federal Regulations, Parts 166 to 199, revised as of October 1, 2002, in part 189, on page 348, remove the second § 189.25–5.

[FR Doc. 03–55517 Filed 8–1–03; 8:45 am]

BILLING CODE 1505–01–D

FEDERAL COMMUNICATIONS COMMISSION

47 CFR Part 73

Radio Broadcasting Services; Marble Falls, TX

CFR Correction

In Title 47 of the Code of Federal Regulations, Parts 70 to 79, revised as of October 1, 2002, in § 73.202(b), in the Table of FM Allotments under Texas, add Marble Falls, Channel 285C2.

[FR Doc. 03–55518 Filed 8–1–03; 8:45 am]

BILLING CODE 1505–01–D

DEPARTMENT OF COMMERCE

National Oceanic and Atmospheric Administration

50 CFR Part 679

[Docket No. 021212307–3037–02; I.D. 072903A]

Fisheries of the Exclusive Economic Zone off Alaska; Species in the Rock Sole/Flathead Sole/''Other Flatfish'' Fishery Category by Vessels Using Trawl Gear in Bering Sea and Aleutian Islands Management Area

AGENCY: National Marine Fisheries Service (NMFS), National Oceanic and Atmospheric Administration (NOAA), Commerce.

ACTION: Closure.

SUMMARY: NMFS is closing directed fishing for species in the rock sole/flathead sole/''other flatfish'' fishery category by vessels using trawl gear in the Bering Sea and Aleutian Islands management area (BSAI). This action is necessary to prevent exceeding the 2003 halibut bycatch allowance specified for the trawl rock sole/flathead sole/''other flatfish'' fishery category in the BSAI.

DATES: Effective 1200 hrs, Alaska local time (A.l.t.), July 31, 2003, through 1200 hrs, A.l.t., December 31, 2003.

FOR FURTHER INFORMATION CONTACT: Josh Keaton, 907–586–7228.

SUPPLEMENTARY INFORMATION: NMFS manages the groundfish fishery in the BSAI exclusive economic zone according to the Fishery Management Plan for the Groundfish Fishery of the Bering Sea and Aleutian Islands Area (FMP) prepared by the North Pacific Fishery Management Council under authority of the Magnuson-Stevens Fishery Conservation and Management Act. Regulations governing fishing by U.S. vessels in accordance with the FMP appear at subpart H of 50 CFR part 600 and CFR part 679.

The 2003 halibut bycatch allowance specified for the trawl rock sole/flathead sole/''other flatfish'' fishery category in the BSAI is 779 metric tons as established by the final 2003 harvest specifications for Groundfish of the BSAI (68 FR 9907, March 3, 2003).

In accordance with § 679.21(e)(7)(v), the Administrator, Alaska Region, NMFS, has determined that the 2003 halibut bycatch allowance specified for the trawl rock sole/flathead sole/''other flatfish'' fishery category in the BSAI has been caught. Consequently, NMFS is closing directed fishing for species in the rock sole/flathead sole/''other flatfish'' fishery category by vessels using trawl gear in the BSAI.

Classification

This action responds to the best available information recently obtained from the fishery. The Assistant Administrator for Fisheries, NOAA (AA), finds good cause to waive the requirement to provide prior notice and opportunity for public comment pursuant to the authority set forth at 5 U.S.C. 553(b)(B) as such requirement is contrary to the public interest. This requirement is contrary to the public interest as it would delay the closure of the fishery, lead to exceeding the 2003 halibut bycatch allowance, and therefore reduce the public's ability to use and enjoy the fishery resource.

The AA also finds good cause to waive the 30–day delay in the effective date of this action under 5 U.S.C. 553(d)(3). This finding is based upon the reasons provided above for waiver of prior notice and opportunity for public comment.

This action is required by § 679.21 and is exempt from review under Executive Order 12866.

Authority: 16 U.S.C. 1801 *et seq.*

Dated: July 29, 2003.

Bruce Morehead,

Acting Director, Office of Sustainable Fisheries, National Marine Fisheries Service.

[FR Doc. 03–19756 Filed 7–30–03; 2:33 pm]

BILLING CODE 3510–22–S

Proposed Rules

Federal Register
Vol. 68, No. 149
Monday, August 4, 2003

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

DEPARTMENT OF AGRICULTURE

Animal and Plant Health Inspection Service

7 CFR Part 331

[Docket No. 03–070–2]

Public Meetings; Listing of Biological Agents and Toxins

AGENCY: Animal and Plant Health Inspection Service, USDA.

ACTION: Notice of cancellation of public meetings.

SUMMARY: We are advising individuals and entities possessing, using, or transferring biological agents and toxins listed in 7 CFR 331.3, as well as other interested parties, that the series of public meetings scheduled for August 2003 are canceled.

FOR FURTHER INFORMATION CONTACT: Dr. Michael J. Firko, Assistant Director, Plant Health Programs, PPQ, APHIS, 4700 River Road Unit 133, Riverdale, MD 20737–1236; (301) 734–8758.

SUPPLEMENTARY INFORMATION: In a document published in the **Federal Register** on July 24, 2003 (68 FR 43660–43661, Docket No. 03–070–1), we gave notice that we would be holding a series of public meetings in August 2003 to provide a forum for discussion of the criteria used to determine whether an agent has the potential to pose a severe threat to plant health or products. We are canceling the meetings that had been scheduled to be held on August 12, 2003 in Charlotte, NC; on August 19, 2003, in Riverdale, MD; and on August 21, 2003, in Sacramento, CA. We will explore alternative methods to consult with appropriate Federal departments and agencies and with scientific experts representing appropriate professional groups. We regret any inconvenience caused by this cancellation.

Done in Washington, DC, this 30th day of July 2003.

Peter Fernandez,

Acting Administrator, Animal and Plant Health Inspection Service.

[FR Doc. 03–19694 Filed 8–1–03; 8:45 am]

BILLING CODE 3410–34–P

DEPARTMENT OF THE INTERIOR

Bureau of Indian Affairs

25 CFR Ch. I

Meeting of the No Child Left Behind Negotiated Rulemaking Committee

AGENCY: Bureau of Indian Affairs, Interior.

ACTION: Announcement of negotiated rulemaking committee meeting.

SUMMARY: The Secretary of the Interior has established an advisory Committee to develop recommendations for proposed rules for Indian education under six sections of the No Child Left Behind Act of 2001. As required by the Federal Advisory Committee Act, we are announcing the date and location of the next meeting of the No Child Left Behind Negotiated Rulemaking Committee.

DATES: The Committee's next meeting will be held August 21–24, 2003. The meeting will begin at 8:30 a.m. (PDT) on Thursday, August 21, and end at noon (PDT) on Sunday, August 24.

ADDRESSES: The meeting will be held at the Grand Hyatt Hotel, 721 Pine Street, Seattle, WA 98101, telephone (206) 774–1234.

FOR FURTHER INFORMATION CONTACT: Barbara James or Shawna Smith, No Child Left Behind Negotiated Rulemaking Project Management Office, PO Box 1430, Albuquerque, NM 87103–1430; telephone (505) 248–7241; fax (505) 248–7242; e-mail *bjames@bia.edu* or *ssmith@bia.edu.* We will post additional information as it becomes available on the Office of Indian Education Programs Web site under ''Negotiated Rulemaking'' at *http//www.oiep.bia.edu.*

SUPPLEMENTARY INFORMATION: For more information on negotiated rulemaking under the No Child Left Behind Act, *see* the **Federal Register** notices published on December 10, 2002 (67 FR 75828) and May 5, 2003 (68 FR 23631) or the Web site at *http//www.oiep.bia.edu* under ''Negotiated Rulemaking.''

At the next meeting the Committee will divide into four work groups: Student Rights and Geographic Boundaries; Tribally Controlled Schools Act/Grants; Adequate Yearly Progress; and Funding and Distribution of Funds. The Committee will also meet in full session each day for work group reports and logistics. All meetings are open to the public. There is no requirement for advance registration for members of the public who wish to attend and observe the Committee meetings or the work group meetings or to make public comments. The agenda for the August 21–24, 2003, meeting is as follows:

Agenda for No Child Left Behind Negotiated Rulemaking Committee Meeting, August 21–24, 2003, Seattle, Washington

August 21

- Opening Remarks—8:30 a.m.
- Public comments (30 minutes).
- Introductions, Logistics, and Housekeeping.
- Plenary Committee considers proposals from Work Groups.
- Work Group meetings.

August 22

- Public comments—8:30–9 a.m.
- Plenary Committee considers proposals from Work Groups.
- Work Group meetings.
- Plenary Committee meeting considers proposals from Work Groups.

August 23

- Public comments—8:30 a.m.
- Work group meetings.
- Plenary Committee meeting hears Work Group reports.

August 24

- Public comments—8:30 a.m.
- Plenary Committee meeting sets agenda for next meeting.
- Closing Remarks.
- Work group meetings.
- Closing—noon.

Dated: July 28, 2003.

Aurene M. Martin,

Acting Assistant Secretary—Indian Affairs.

[FR Doc. 03–19678 Filed 8–1–03; 8:45 am]

BILLING CODE 4310–6W–P

ENVIRONMENTAL PROTECTION AGENCY

40 CFR Parts 19 and 27

[FRL–7539–3]

Civil Monetary Penalty Inflation Adjustment Rule

AGENCY: Environmental Protection Agency (EPA)

ACTION: Proposed Rule; Technical Corrections.

SUMMARY: EPA is correcting the proposed rule that appeared in the July 3, 2003 **Federal Register** at (68 FR 39882), entitled ''Civil Monetary Penalty Inflation Adjustment Rule,'' as mandated by the Debt Collection Improvement Act of 1996, to adjust EPA's civil monetary penalties for inflation on a periodic basis. This notice creates no new regulatory requirements. Rather, it corrects the effective date for the proposed rule which was mistakenly listed as July 3, 2003 in the **Federal Register** notice of the same date.

DATES: The comment period for the previously published proposal (68 FR 39882, July 3, 2003) ends on August 4, 2003.

ADDRESSES: Mail written comments to the Docket Office, Enforcement & Compliance Docket and Information Center (2201AT), Docket Number EC–2001–008, U.S. Environmental Protection Agency, EPA West, 1200 Pennsylvania Avenue, NW., Room B133, Washington, DC 20460 (in triplicate, if possible). Please use a font size no smaller than 12. Written comments may be delivered in person to: U.S. Environmental Protection Agency, EPA West, 1301 Constitution Avenue, NW., Room B133, Washington, DC 20460. Comments may also be submitted electronically to *docket.oeca@epa.gov* or faxed to (202) 566–1511. Attach electronic comments as an ASCii (text) file, and avoid the use of special characters and any form of encryption. Be sure to include the docket number, EC–2001–008, on your document. Public comments, if any, may be reviewed at the Enforcement and Compliance Docket Information Center, U.S. Environmental Protection Agency, EPA West, 1301 Constitution Avenue, NW., Room B133, Washington, DC 20460. Persons interested in reviewing this docket may do so by calling (202) 566–1512.

FOR FURTHER INFORMATION CONTACT: David Abdalla, Office of Regulatory Enforcement, Multimedia Enforcement Division, Mail Code 2248A, 1200 Pennsylvania Avenue, NW., Washington, DC 20460, (202) 564–2413.

SUPPLEMENTARY INFORMATION:

I. Reasons and Basis for Today's Notice

In its review of the July 3, 2003 proposed rule (68 FR 39882), issued pursuant to the Debt Collection Improvement Act of 1996 (Pub. L. 104–134, 110 Stat. 1321), EPA identified errors in certain sections of the regulatory language of the proposal referring to the effective date. Today's notice corrects these errors to reflect that the effective date of the final rule will be the date the final rule is published, and not July 3, 2003, the date on which the proposed rule was published.

II. Public Comment Period

Today's notice does not create any new regulatory requirement. EPA believes that the July 3, 2003 notice presented the substance of the proposed rule sufficiently to allow interested persons to understand all aspects of the proposed rule and to make comments. Consequently, EPA finds that it is not necessary to extend the comment period for the proposed rule. The comment period will still close on August 4, 2003.

Dated: July 29, 2003.

John Peter Suarez,

Assistant Administrator for Enforcement and Compliance Assurance.

The following corrections are made to FRL–7522–4 Civil Monetary Penalty Inflation Adjustment Rule; Proposed Rule, published in the **Federal Register** on July 3, 2003 (68 FR 39882):

1. In Section 19.2 of the regulatory text, change both references to the date ''July 3, 2003'' to ''[date of publication of final rule].''

2. In footnote 1 to Section 27.3(a)(1)(iv) of the regulatory text, change the reference to the date ''July 3, 2003'' to ''[date of publication of final rule].''

[FR Doc. 03–19738 Filed 8–1–03; 8:45 am]

BILLING CODE 6560–50–P

Notices

Federal Register
Vol. 68, No. 149
Monday, August 4, 2003

This section of the FEDERAL REGISTER contains documents other than rules or proposed rules that are applicable to the public. Notices of hearings and investigations, committee meetings, agency decisions and rulings, delegations of authority, filing of petitions and applications and agency statements of organization and functions are examples of documents appearing in this section.

DEPARTMENT OF AGRICULTURE

Food Safety and Inspection Service

[Docket No. 03–015N]

FSIS Safety and Security Guidelines for the Transportation and Distribution of Meat, Poultry, and Egg Products; Notice of Availability

AGENCY: Food Safety and Inspection Service, USDA.

ACTION: Notice of Availability; Request for public comments and information.

SUMMARY: The Food Safety and Inspection Service is announcing the availability of the Agency's current safety and security guidelines for the transportation and distribution of meat, poultry, and egg products. These guidelines were developed to assist facilities and shippers of all sizes to improve food safety and security in the handling of FSIS-regulated products. These guidelines include measures to improve food security during the loading, transport, in-transit storage, and unloading of meat, poultry, and egg products. In these guidelines, FSIS strongly recommends that shippers and receivers, as well as transporters, of these products develop controls for ensuring the security of products through all phases of distribution. Such controls are necessary to protect the products from intentional, as well as unintentional, contamination.

The Agency has decided to collect and analyze data on these transportation guidelines, which include both food safety and food security components, and determine whether there is a need to adopt any of these guidelines as regulations. Consequently, in this notice, FSIS is asking a series of questions about the transportation guidelines to solicit information from interested parties.

DATES: Submit written comments on the transportation guidelines and answers to the questions to the FSIS Docket Room no later than October 3, 2003.

ADDRESSES: Submit one original and two copies of all written comments on the proposed transportation guidelines and responses to questions to: FSIS Docket Room, U.S. Department of Agriculture, Food Safety and Inspection Service, Room 102, Cotton Annex, Washington, DC 20250–3700. All comments and responses received will be considered part of the public record and will be available for viewing in the Docket Room between 8:30 a.m. and 4:30 p.m., Monday through Friday, except Federal holidays. Copies of the *FSIS Safety and Security Guidelines for the Transportation and Distribution of Meat, Poultry, and Egg Products* will also be available in the FSIS Docket Room between 8:30 a.m. and 4:30 p.m., Monday through Friday, except Federal holidays and on the Internet at: *http://www.fsis.usda.gov/oa/topics/transportguide.htm.* Printed copies of the Guidelines may be requested from the USDA FSIS Office of Congressional and Public Affairs, 1400 Independence Avenue SW., Room 175, Washington, DC 20250–3700; telephone (202) 720–9113. These guidelines are available in both English and Spanish.

FOR FURTHER INFORMATION CONTACT: Dr. Perfecto Santiago, Assistant Deputy Administrator, Program Development Staff, Office of Policy and Program Development, Food Safety and Inspection Service, U.S. Department of Agriculture, Washington, DC 20250–3700; telephone (202) 205–0699 or fax (202) 401–1760.

SUPPLEMENTARY INFORMATION:

Background

In May 2002, FSIS issued the *FSIS Security Guidelines for Food Processors* to assist Federal- and State-inspected meat, poultry, and egg product establishments in identifying ways to strengthen their food security protection. At that time, the Agency noted that it would continue to provide guidance to businesses engaged in the production and distribution of FSIS-regulated foods, and work with the Food and Drug Administration (FDA) and other agencies to provide guidance for the handling of meat, poultry and egg products during transportation, distribution, and storage.

FSIS recognizes that food producers, transporters, and distributors have a vested interest in making food security, as well as food safety, a top priority. FSIS will continue to seek input from stakeholders in developing guidance on food security and food safety matters. To ensure that the transporters and distributors of meat, poultry, and egg products have access to information to help them protect the food that they handle from threats, FSIS has developed the *FSIS Safety and Security Guidelines for the Transportation and Distribution of Meat, Poultry, and Egg Products*. These guidelines provide safety measures to prevent physical, chemical, or microbiological contamination of food products during transportation and storage, including measures that deal specifically with the prevention of intentional contamination due to criminal or terrorist acts.

Meat, poultry, and egg products are transported by air, sea, and land. Hazards may be present, or intentionally introduced, at any point during transportation and distribution, but are most likely to occur at changes between transportation modes and during loading and unloading. Meat, poultry, and egg products frequently are transported multiple times and often stored and further processed on their way to the consumer. These products could be exposed to hazards at each step in that process. For example, a product might be transported from a slaughter establishment to a raw-product processing establishment, next to a further processing plant, then to a distribution center, and finally to a retail market for purchase by the consumer.

The guidelines were developed to assist facilities and shippers of all sizes, as well as Federal, State, and local authorities, to improve food safety and security in the handling of FSIS-regulated products at every step in the transportation and distribution process.

While these guidelines are voluntary, and parties may choose to adopt measures suggested by many different sources, it is vital that all parties in the transportation and distribution process for meat, poultry, and egg products take steps to ensure the security of their operations, the integrity of their processes and products, and the continued safety of the products that they handle.

The first section of these guidelines provides food safety measures that are designed to help prevent contamination of food products during transportation and storage. The second section of the guidelines deals specifically with food security measures that may be taken to prevent deliberate contamination as part of criminal or terrorist acts. Both sections apply to all points of shipment from the processor to final delivery at the retail store, restaurant, or other facility serving consumers, as well as at any intermediate stops (*i.e.*, intermediate warehouses, transfer, and handling facilities such as airports, break-bulk terminals, rail sidings, etc.) during shipment prior to final delivery. These guidelines are applicable whether the potential contamination occurs due to an intentional or unintentional act. Implementation of these guidelines will assist all participants in the transportation and distribution process in preventing such acts or in responding to them effectively should they occur.

The food safety section of the guidelines has a long history of development by FSIS. In February, 1995, the Pathogen Reduction/HACCP proposed rule (60 FR 6774) was published and in this proposal FSIS stated its commitment to develop standards to help ensure the safe handling of meat and poultry products during transportation and storage. A Technical Analysis Group (TAG) was used by FSIS and the Department of Transportation (DOT) in April 1995, to address the safety of food after it left the production facility and began to move through commerce. The TAG identified the primary hazards associated with the transport of perishable foods and recommended reasonable controls that might be employed by industry to ensure food safety.

Subsequent to the TAG report, FSIS and FDA issued an Advance Notice of Proposed Rulemaking (ANPR) on November 22, 1996 (61 FR 59372), seeking information and comments on approaches the agencies might take to foster food safety improvements that might be needed in the transportation and storage of foods. Responses to the TAG Report and the ANPR were used in the development of the food safety recommendations in the *FSIS Safety and Security Guidelines for the Transportation and Distribution of Meat, Poultry, and Egg Products* now being made available to the public.

The food security section of the guidelines addresses the possibility of deliberate attacks on the domestic food supply by individuals or groups and is a direct result of heightened concerns about homeland security that have resulted since the terrorist attacks on September 11, 2001.

Request for Comments and Information

FSIS has decided to collect and analyze more data on the possible impacts of these guidelines before deciding whether it should proceed with rulemaking. The Agency invites public comment on how to strengthen the safety and security of meat, poultry, and egg products during the transportation and distribution process. The Agency is especially interested in informed responses regarding both food safety and food security to the following questions:

- Are there problems regarding food safety and food security in the transportation, distribution, or storage processes that the guidelines fail to address; or if all issues are addressed, are there flaws in the approaches described in the guidelines?
- If the guidelines can be improved, how could they be improved?
- Will transporters, distributors, and storage facilities have difficulty complying with these guidelines? If so, what difficulties do the guidelines pose? Would the guidelines pose greater, or different, difficulties for small firms than for large firms?
- Should the Agency initiate rulemaking to adopt the guidelines as regulations or will the guidelines be sufficiently effective if they are only voluntary?
- Would mandatory implementation of these transportation guidelines have any unusual or particularly significant impacts on any portion of the food distribution chain? If so, who would be affected and how?
- Would mandating these guidelines by regulation increase costs to transportation, distribution, and storage facilities? If so, would this result in increased costs to the consumer as the end user?

FSIS will consider all relevant comments in deciding whether any of the transportation guidelines should be proposed as a regulation. Should the Agency decide to propose a rule, it will summarize all of the comments and information that it receives and include the summary in the proposed rule.

Additional Public Notification

Public awareness of all segments of rulemaking and policy development is important. Consequently, in an effort to better ensure that minorities, women, and persons with disabilities are aware of this notice, FSIS will announce it and make copies of this **Federal Register** publication available through the FSIS Constituent Update. FSIS provides a weekly Constituent Update, which is communicated via Listserv, a free e-mail subscription service. In addition, the update is available online through the FSIS web page located at *http://www.fsis.usda.gov.* The update is used to provide information regarding FSIS policies, procedures, regulations, **Federal Register** notices, FSIS public meetings, industry recalls, and any other types of information that could affect or would be of interest to our constituents/stakeholders. The constituent Listserv consists of industry, trade, and farm groups, consumer interest groups, allied health professionals, scientific professionals, and other individuals that have requested to be included. Through the Listserv and web page, FSIS is able to provide information to a much broader, more diverse audience.

For more information contact the Congressional and Public Affairs Office, at (202) 720–9113. To be added to the free e-mail subscription service (Listserv) go to the ‘‘Constituent Update’’ page on the FSIS Web site at *http://www.fsis.usda.gov/oa/update/update.htm.*

Click on the ‘‘Subscribe to the Constituent Update Listserv’’ link, then fill out and submit the form.

Done in Washington, DC, on July 29, 2003.

Linda Swacina,

Acting Administrator.

[FR Doc. 03–19659 Filed 8–1–03; 8:45 am]

BILLING CODE 3410–DM–P

DEPARTMENT OF COMMERCE

Submission for OMB Review; Comment Request

DOC has submitted to the Office of Management and Budget (OMB) for clearance the following proposal for collection of information under the provisions of the Paperwork Reduction Act (44 U.S.C. chapter 35).

Agency: U.S. Census Bureau.

Title: Monthly Survey of Residential Alterations and Repairs.

Form Number(s): SORAR–705.

Agency Approval Number: 0607–0130.

Type of Request: Revision of a currently approved collection.

Burden: 8,400 hours.

Number of Respondents: 2,800.

Avg. Hours Per Response: 15 minutes.

Needs and Uses: The U.S. Census Bureau is requesting a revision of the currently approved collection for the Quarterly Survey of Residential Alterations and Repairs. The form used to collect this information is SORAR–705. The Census Bureau is responsible for preparing estimates of the expenditures for residential improvement and repairs. This segment of the construction industry amounted to more than $170 billion in 2002. While the majority of the data are gathered from the Consumer Expenditure Survey, a portion of the data ($50 billion in 2002) are collected on the SORAR–705 form. This survey is mailed to a sample of owners of rental or vacant residential properties. Since residential improvement and repairs are a large and growing economic sector, any measure of the construction industry would be incomplete without the inclusion of these data.

In an effort to make our data dissemination more timely, the survey will begin monthly data collection for the January 2004 survey month. To improve the scope of the survey, we will begin to collect expenditures for wall-to-wall carpeting, kitchen appliances, manufactured housing, and rented condominiums that are excluded from the current data collection. To reduce the respondent burden of monthly data collection, we will decrease by 20% the number of improvement queries on the monthly form. For example, siding work done as an ''alteration'' and siding work done as a ''major replacement'' are now combined into one siding improvement. Also, we have removed one question from the form, ''When was this building or complex originally built?'

The Census Bureau uses the information collected on the SORAR–705 form to publish improvement and repair expenditures for rental and vacant residential properties. Data on improvements and repairs to owner-occupied properties are collected in the Consumer Expenditure Survey. Combined published estimates are used by a variety of private businesses and trade associations for marketing studies, economic forecasts and assessments of the construction industry. They also provide all levels of Government with a tool to evaluate economic policy and measure progress toward established goals. For example, the Bureau of Economic Analysis (BEA) uses the Census Bureau's improvement statistics to develop the residential structures component of the gross private domestic investment in the national income and product accounts.

Affected Public: Individuals or households; business or other for-profit; State, local or Tribal government.

Frequency: Monthly.

Respondent's Obligation: Voluntary.

Legal Authority: Title 13 U.S.C., Section 182.

OMB Desk Officer: Susan Schechter, (202) 395–5103.

Copies of the above information collection proposal can be obtained by calling or writing Diana Hynek, Departmental Paperwork Clearance Officer, (202) 482–0266, Department of Commerce, room 6625, 14th and Constitution Avenue, NW., Washington, DC 20230 (or via the Internet at *dhynek@doc.gov*).

Written comments and recommendations for the proposed information collection should be sent within 30 days of publication of this notice to Susan Schechter, OMB Desk Officer either by fax (202–395–7245) or e-mail (*susan_schechter@omb.eop.gov*).

Dated: July 29, 2003.

Madeleine Clayton,

Management Analyst, Office of the Chief Information Officer.

[FR Doc. 03–19656 Filed 8–1–03; 8:45 am]

BILLING CODE 3510–07–P

DEPARTMENT OF COMMERCE

Submission for OMB Review; Comment Request

DOC has submitted to the Office of Management and Budget (OMB) for clearance the following proposal for collection of information under the provisions of the Paperwork Reduction Act (44 U.S.C. Chapter 35).

Agency: Bureau of Economic Analysis (BEA).

Title: Initial Report on a Foreign Person's Direct or Indirect Acquisition, Establishment, or Purchase of the Operating Assets, Including Real Estate, of a U.S. Business Enterprise.

Form Number(s): BE–13, BE–14, and BE–13 Supplement C (Exemption Claim).

Agency Approval Number: 0608–0035.

Type of Request: Extension of a currently approved collection.

Burden: 900 hours.

Number of Respondents: 600 annually.

Avg Hours Per Response: 1.5 hours.

Needs and Uses: The Initial Report on a Foreign Person's Direct or Indirect Acquisition, Establishment, or Purchase of the Operating Assets, of a U.S. Business Enterprise, Including Real Estate (Form BE–13) and the Report by a U.S. Person Who Assists or Intervenes in the Acquisition of a U.S. Business Enterprise by, or Who Enters Into a Joint Venture with, a Foreign Person (Form BE–14) obtain initial data on new foreign direct investment in the United States. Survey form BE–13 collects information on the cost of new foreign direct investment in the United States, the sources of funding (*i.e.,* the foreign parent group and/or existing U.S. affiliates of the foreign parent), and limited financial and operating data for the U.S. entity being established or acquired; the survey also collects identification information about the U.S. entity being established or acquired and about the new foreign owner. Survey form BE–14 collects information from U.S. persons who assist in an investment transaction, such as a real estate broker or attorney, or who enter into a U.S. joint venture with a foreign person. The primary purpose of this information collection is to identify new U.S. affiliates that should be included in BEA's estimates of foreign direct investment in the United States. The information is needed to update data on the universe of U.S. affiliates to ensure that it is complete, and to determine whether the new affiliates exceed the exemption criteria required for reporting in related benchmark, annual, and quarterly surveys of foreign direct investment conducted by BEA. The information is also used to improve the accuracy of universe estimates derived from the ongoing quarterly and annual surveys, which are sample surveys.

Many State and local governments have taken steps to attract new foreign direct investment to their localities. To make informed policy decisions concerning such investment, it is essential that government entities, including the U.S. Government, have the means to measure foreign direct investment in the United States, monitor changes in it, and assess its economic impact. Data from the survey are intended to be general purpose statistics on foreign direct investment that are readily available to answer any number of research and policy questions when they arise.

Affected Public: U.S. businesses or other for-profit institutions.

Frequency: One-time survey.

Respondent's Obligation: Mandatory.

Legal Authority: Title 22 U.S.C., Sections 3101–3108, as amended.

OMB Desk Officer: Paul Bugg, (202) 395–3093.

You may obtain copies of the above information collection proposal by calling or writing Diana Hynek, Departmental Paperwork Clearance Officer, Office of the Chief Information Officer, (202) 482–0266, Department of Commerce, Room 6625, 14th and Constitution Avenue, NW., Washington, DC 20230, or via the Internet at *dHynek@doc.gov.*

Send comments on the proposed information collection within 30 days of publication of this notice to Paul Bugg, OMB Desk Officer, via the Internet at *pbugg@omb.eop.gov,* or by fax at (202) 395–7245.

Dated: July 29, 2003.

Madeleine Clayton,

Management Analyst, Office of the Chief Information Officer.

[FR Doc. 03–19668 Filed 8–1–03; 8:45 am]

BILLING CODE 3510–06–P

DEPARTMENT OF COMMERCE

International Trade Administration

[A–570–851]

Certain Preserved Mushrooms From the People's Republic of China: Intent To Rescind Antidumping Duty New Shipper Review

AGENCY: Import Administration, International Trade Administration, Department of Commerce.

ACTION: Notice of intent to rescind antidumping duty new shipper review.

SUMMARY: In response to requests from Xiamen Zhongjia Imp. & Exp. Co., Ltd. and Zhangzhou Longhai Minhui Industry and Trade Co., Ltd., the Department of Commerce initiated a new shipper review of the antidumping duty order on certain preserved mushrooms from the People's Republic of China. The period of review is February 1, 2002, through July 31, 2002.

For the reasons discussed below, we intend to rescind the new shipper review with respect to both companies listed above. We invite interested parties to comment on this intent to rescind.

EFFECTIVE DATE: August 4, 2003.

FOR FURTHER INFORMATION CONTACT: Brian C. Smith, Davina Hashmi, or James Mathews, Office of AD/CVD Enforcement 1, Import Administration, International Trade Administration, U.S. Department of Commerce, 14th Street and Constitution Avenue, NW., Washington, DC, 20230; telephone: (202) 482–1766, (202) 482–0984, and (202) 482–2778, respectively.

SUPPLEMENTARY INFORMATION:

Background

The Department of Commerce (''the Department'') initiated a new shipper review covering Xiamen Zhongjia Imp. & Exp. Co., Ltd. (''Zhongjia''), and Zhangzhou Longhai Minhui Industry and Trade Co., Ltd. (''Minhui''), on September 30, 2002. This initiation was based on, among other things, each company's certification that it was both the exporter and producer of the subject merchandise for which it requested a new shipper review. *See Certain Preserved Mushrooms from the People's Republic of China: Initiation of New Shipper Antidumping Duty Review*, 67 FR 62438 (October 7, 2002) (''*Initiation Notice*''). On October 8, 2002, the Department issued the antidumping duty questionnaire to both companies.

During the period December 2002 through July 2003, the Department received responses to sections A, C, and D of the Department's original and two supplemental questionnaires from Zhongjia and Minhui. In these responses, Zhongjia and Minhui revealed that they were not the producer of the subject merchandise they exported to the United States during the period of review (''POR'').

Scope of the Order

The products covered by this order are certain preserved mushrooms whether imported whole, sliced, diced, or as stems and pieces. The preserved mushrooms covered under this order are the species *Agaricus bisporus* and *Agaricus bitorquis*. ''Preserved mushrooms'' refer to mushrooms that have been prepared or preserved by cleaning, blanching, and sometimes slicing or cutting. These mushrooms are then packed and heated in containers including, but not limited to, cans or glass jars in a suitable liquid medium, including, but not limited to, water, brine, butter or butter sauce. Preserved mushrooms may be imported whole, sliced, diced, or as stems and pieces. Included within the scope of this order are ''brined'' mushrooms, which are presalted and packed in a heavy salt solution to provisionally preserve them for further processing.

Excluded from the scope of this order are the following: (1) All other species of mushroom, including straw mushrooms; (2) all fresh and chilled mushrooms, including ''refrigerated'' or ''quick blanched mushrooms''; (3) dried mushrooms; (4) frozen mushrooms; and (5) ''marinated,'' ''acidified'' or ''pickled'' mushrooms, which are prepared or preserved by means of vinegar or acetic acid, but may contain oil or other additives.[1]

The merchandise subject to this order is classifiable under subheading: 2003.10.0127, 2003.10.0131, 2003.10.0137, 2003.10.0143, 2003.10.0147, 2003.10.0153, and 0711.51.0000 of the Harmonized Tariff Schedule of the United States (''HTS''). Although the HTSUS subheadings are provided for convenience and customs purposes, the written description of the scope of this order is dispositive.

Intent To Rescind Review

For the reasons stated below, we intend to rescind the new shipper review with respect to Zhongjia and Minhui.

Specifically, we intend to rescind the new shipper review with respect to both companies because neither exporter provided us with the proper certification, pursuant to 19 CFR 351.214(b)(2)(ii)(B), for entitlement to a new shipper review.

In order to qualify for a new shipper review under 19 CFR 351.214(b)(2)(ii), a company which is an exporter but not the producer of the subject merchandise for which it requests such a review must provide, among other things, (1) a certification that it did not export subject merchandise to the United States during the period of investigation (''POI''), and (2) a certification from the person or company which produced or supplied the subject merchandise that the producer or supplier did not export the subject merchandise to the United States during the POI (*see* 19 CFR 351.214(2)(ii)(A) and (B)).

As the basis for initiating this new shipper review, both Zhongjia and Minhui each stated and certified in its request for review that it was the exporter and producer of the subject merchandise. Therefore, for purposes of initiating this review and based on the certifications provided by both Zhongjia and Minhui in accordance with 19 CFR 351.214(b)(2)(i), the Department was led to believe that both companies also produced the merchandise for which each requested a review (*see* page 1 of Zhongjia's August 30, 2002, submission and page 1 of Minhui's August 30, 2002, submission). Zhongjia and Minhui appeared to be in compliance with the certification requirements for a new shipper which was both an exporter and producer of the subject merchandise for which the new shipper review request had been filed, and it was on this basis the Department initiated a new shipper review for each company (*see* 19 CFR 351.214(b)(i) and *Initiation Notice*, 68 FR at 62439). Relying on the certification provided by each respondent, the Department issued instructions to the U.S. Bureau of Customs and Border Protection (''BCBP'') in accordance with section 751(a)(2)(B) of the Tariff Act of 1930, as amended (''the Act''), which allowed, at the option of the importer, the posting,

[1] On June 19, 2000, the Department affirmed that ''marinated,'' ''acidified,'' or ''pickled'' mushrooms containing less than 0.5 percent acetic acid are within the scope of the antidumping duty order. *See* ''Recommendation Memorandum—Final Ruling of Request by Tak Fat, *et al.* for Exclusion of Certain Marinated, Acidified Mushrooms from the Scope of the Antidumping Duty Order on Certain Preserved Mushrooms from the People's Republic of China,'' dated June 19, 2000.

until the completion of the review, of a bond or security in lieu of a cash deposit for each entry of the subject merchandise for which each respondent was both the producer and exporter (*see Initiation Notice*, 67 FR at 62439).

During the course of conducting this review and in response to the Department's original and supplemental questionnaires, however, both companies provided factors of production data which indicated that neither company was the producer of the subject merchandise it reported in its U.S. sales listing (*see* page 5 of Zhongjia's December 4, 2002, Section A questionnaire response, page 2 of Zhongjia's December 4, 2002, Section D questionnaire response, and pages 8 through 14 of Zhongjia's July 3, 2003, second supplemental questionnaire response; *see* page 5 of Minhui's December 4, 2002, Section A questionnaire response, page 2 of Minhui's December 4, 2002, Section D response, and pages 9 through 11 of Minhui's July 3, 2003, second supplemental questionnaire response). This data conflicted with each company's certification, for purposes of initiation, that it was both the exporter and producer of the merchandise subject to this review. Consequently, Zhongjia and Minhui misstated the facts when each claimed in its respective new shipper review request that it was both the exporter and producer of the merchandise subject to this review.

Because Zhongjia and Minhui did not provide a certification from the respective producers of the subject merchandise they sold or exported to the United States during the POR in accordance with 19 CFR 351.214(b)(2)(ii)(B), neither respondent met the minimum requirements for an entitlement to a new shipper review. Had we realized that these exporters were not also the producers of the merchandise for which they were requesting a new shipper review at the initiation stage, we would not have initiated this review. The certification omission is fundamental to the initiation decision, and the exporters' failure to provide the necessary certifications, in addition to their misleading statements contained within the submitted certifications that these exporters were also ''producers'' of subject merchandise, would have led the Department to determine not to initiate a new shipper review of these exporters.

Consequently, the Department determines that it should not conduct further a review that was initiated based on faulty data (*see, e.g.*, *Fresh Garlic from the People's Republic of China: Partial Rescission of Antidumping Duty New Shipper Review*, 67 FR 65782 (October 28, 2002)). To do so permits manipulation of the new shipper review provision and allows parties, such as Zhongjia and Minhui, to reap the benefit of the new shipper bonding provision without meeting the minimal threshold requirements for entitlement to the new shipper review process (*see* Import Administration Policy Bulletin Number 03.2, entitled ''Combination Rates in New Shipper Reviews,'' dated March 4, 2003). Indeed, if an exporter ships to the United States merchandise produced by another entity but, because of mis-certification, its importers receive the bond benefit for its self-produced merchandise during the new shipper review, then the wrong exporter/producer combination benefits from the bonding privilege as long as the new shipper review continues. Thus, rescission of the new shipper review rectifies this problem.

Because each respondent exporter's certification contained in its August 30, 2002, request for a new shipper review did not also contain a certification from the producer of the subject merchandise as required by 19 CFR 351.214(b)(2)(ii)(B), which each respondent was required to provide because neither company produced the merchandise subject to this review, as affirmed by the information contained in subsequent questionnaire responses, we find that there is a sufficient basis to rescind this new shipper review with respect to both companies for the reasons outlined above.

Comment Period

Interested parties who wish to request a hearing, or to participate if one is requested, must submit a written request to the Assistant Secretary for Import Administration, Room B–099, within 30 days of the date of publication of this notice. Requests should contain: (1) The party's name, address, and telephone number; (2) the number of participants; and (3) a list of issues to be discussed. *See* 19 CFR 351.310(c). Any hearing, if requested, will be held on September 10, 2003. Parties should confirm by telephone the time, date, and place of the hearing 48 hours before the scheduled time.

Issues raised in the hearing will be limited to those raised in case briefs and rebuttal briefs. Case briefs from interested parties may be submitted not later than August 27, 2003. Rebuttal briefs, limited to issues raised in the case briefs, will be due not later than September 3, 2003. Parties who submit case briefs or rebuttal briefs in this proceeding are requested to submit with each argument (1) a statement of the issue and (2) a brief summary of the argument. Parties are also encouraged to provide a summary of the arguments not to exceed five pages and a table of statutes, regulations, and cases cited.

The Department will issue its final decision, including the results of its analysis of issues raised in any such written briefs or at the hearing, if held, not later than 90 days after the date of issuance of this notice.

Notification

If we rescind this review, bonding will no longer be permitted to fulfill security requirements for shipments from Minhui or Zhongjia of certain preserved mushrooms from the PRC entered, or withdrawn from warehouse, for consumption on or after the publication date of the final rescission notice. The cash deposit rate required for subject merchandise from the PRC NME entity (including Zhongjia and Minhui), entered or withdrawn from warehouse, for consumption on or after the publication of the final rescission notice will continue to be the PRC-wide rate of 198.63 percent. These deposit requirements shall remain in effect until publication of the final results of the next administrative review.

This preliminary rescission notice is in accordance with sections 751(a)(2)(B) and 777(i) of the Act and 19 CFR 351.214.

Dated: July 28, 2003.

Joseph A. Spetrini,

Acting Assistant Secretary for Grant Aldonas, Under Secretary.

[FR Doc. 03–19754 Filed 8–1–03; 8:45 am]

BILLING CODE 3510–DS–P

DEPARTMENT OF COMMERCE

International Trade Administration

[A–533–810]

Stainless Steel Bar From India: Extension of Time Limit for Preliminary Results in Antidumping Duty Administrative Review

AGENCY: Import Administration, International Trade Administration, Department of Commerce

ACTION: Extension of time limit for preliminary results of antidumping duty administrative review

EFFECTIVE DATE: August 4, 2003.

FOR FURTHER INFORMATION CONTACT: Michael Strollo at (202) 482–0629, Office of AD/CVD Enforcement 2, Import Administration, International Trade Administration, U.S. Department of Commerce, 14th Street and Constitution Avenue, NW., Washington DC 20230.

SUPPLEMENTARY INFORMATION: On March 25, 2003, the Department of Commerce (the Department) published in the **Federal Register** a notice of initiation of administrative review of the antidumping duty order on stainless steel bar from India. *See Initiation of Antidumping and Countervailing Duty Administrative Reviews and Requests for Revocation in Part*, 68 FR 14394 (March 25, 2003). The period of review is February 1, 2002, through March 31, 2003. The review covers seven exporters of the subject merchandise to the United States.

In accordance with section 751(a)(3)(A) of the Tarriff Act of 1930, as amended (the Act), the Department shall make a preliminary determination in an administrative review of an antidumping duty order within 245 days after the last day of the anniversary month of the date of publication of the order. The Act provides further, however, that the Department may extend the 245-day period to 365 days if it determines it is not practicable to complete the review within the foregoing time period. Due to the large number of respondents and the time required to review and analyze multiple supplemental responses, it is not practicable to complete this review within the time limit mandated by section 751(a)(3)(A) of the Act. Therefore, we have fully extended the deadline until February 28, 2004.

This extension is in accordance with section 751(a)(3)(A) of the Act.

Dated: July 29, 2003.

Laurie Parkhill,

Acting Deputy Assistant Secretary for Import Administration.

[FR Doc. 03–19755 Filed 8–1–03; 8:45 am]

BILLING CODE 3510–DS–P

DEPARTMENT OF COMMERCE

National Oceanic and Atmospheric Administration

Federal Consistency Appeal by Millennium Pipeline From an Objection by the New York Department of State

AGENCY: National Oceanic and Atmospheric Administration (NOAA), Department of Commerce (Commerce).

ACTION: Notice of closure—administrative appeal decision record.

SUMMARY: This announcement provides notice that the decision record has been closed for an administrative appeal filed with the Department of Commerce by the Millennium Pipeline Company (Consistency Appeal of Millennium Pipeline Company, L.P.).

DATES: The decision record for the Millennium Pipeline Company's administrative appeal was closed on July 24, 2003.

ADDRESSES: Materials from the appeal record are available at the Internet site *http://www.orc.doc.gov/czma.htm* and at the Office of the General Counsel for Ocean Services, National Oceanic and Atmospheric Administration, U.S. Department of Commerce, 1305 East-West Highway, Silver Spring, MD 20910.

FOR FURTHER INFORMATION CONTACT: Branden Blum, Senior Counselor, Office of the General Counsel for Ocean Services, via e-mail at *gcos.inquiries@noa.gov,* or at 301–713–2967, extension 186.

SUPPLEMENTARY INFORMATION: In June 2002, the Millennium Pipeline Company, L.P. (Millennium or Appellant) filed a notice of appeal with the Secretary of Commerce (Secretary) pursuant to section 307(c)(3)(A) of the Coastal Zone Management Act of 1972 (CZMA), as amended 16 U.S.C. 1451 *et seq.,* and the Department of Commerce's implementing regulations, 15 CFR part 930, subpart H, (revised, effective January 8, 2001). The appeal was taken from an objection by the New York Department of State (State) to Millennium's consistency certification for U.S. Army Corps of Engineers and Federal Energy Regulatory Commission permits to construct and operate a natural gas pipeline spanning approximately 420 miles from the U.S./Canada border to a terminus outside of New York City. The certification indicated that the project is a consistent with New York State's coastal management program. The project would traverse Lake Erie and cross the Hudson River, affecting the natural resources or land and water uses of New York's coastal zone.

The Appellant requested the Secretary to override the State's consistency objection for a procedural reason, concerning the timing of the State's objection to the Millennium project. The Appellant also requested an override of the State's objection on the two substantive grounds provided in the CZMA. The first ground requires the Secretary to determine that the proposed activity is ''consistent with the objective'' of the CZMA. The second substantive ground for overriding a State's objection considers whether the proposed activity is necessary in the interest of national security. Decisions for CZMA administrative appeals are based on information contained in a decision record. The Millennium appeal decision record includes materials submitted by the parties, the public and interested federal agencies, and was closed on July 24, 2003. It is expected that no further information, briefs or comments will be considered in deciding the appeal.

The CZMA requires that a notice be published in the **Federal Register** indicting the date on which the decision record has been closed. 16 U.S.C. 1465(a). A final decision of the Millennium appeal is to be issued no later than 90 days after the date of publication of this notice. 16 U.S.C. 1465(a). The deadline may be extended by publishing (within the 90-day period) a subsequent notice explaining why a decision cannot be issued within the time frame. In this event, a final decision is to be issued no later that 45 days after the date of publication of the subsequent notice. 16 U.S.C. 1465(b).

Additional information about the Millennium appeal and the CZMA appeals process is available from the Department of Commerce CZMA appeals Web site *http://www.ogc.doc.gov/czma.htm.*

(Federal Domestic Assistance Catalog No. 11.419 Coastal Zone Management Program Assistance.)

Dated: July 28, 2003.

James R. Walpole,

General Counsel.

[FR Doc. 03–19591 Filed 8–1–03; 8:45 am]

BILLING CODE 3510–08–M

DEPARTMENT OF COMMERCE

National Oceanic and Atmospheric Administration

[I.D. 072803A]

ICCAT Advisory Committee; Public Meeting

AGENCY: National Marine Fisheries Service (NMFS), National Oceanic and Atmospheric Administration (NOAA), Commerce.

ACTION: Notice of public meeting.

SUMMARY: The Advisory Committee to the U.S. Section to the International Commission for the Conservation of Atlantic Tunas (ICCAT), in conjunction with the International Fisheries Division of NMFS, announces a regional public meeting to be held in August in the U.S. Virgin Islands.

DATES: The meeting is scheduled for August 14, 2003, from 6 p.m. to 9 p.m.

ADDRESSES: The meeting will be held in St. Thomas, U.S. Virgin Islands at the

Virgin Island Game Fishing Club at Red Hook, 6501 Red Hook Plaza, St. Thomas, V.I. 00802.

FOR FURTHER INFORMATION CONTACT: Erika Carlsen at (301) 713–2276.

SUPPLEMENTARY INFORMATION: The following topics may be presented to the public for discussion at the regional public meeting:

(1) Background on ICCAT

(2) Information on the Advisory Committee and Commissioners

(3) Status of Highly Migratory Species Managed by ICCAT

(4) Topics for the 2003 ICCAT Annual Meeting

Representatives from the Advisory Committee to the U.S. Section to ICCAT and NMFS will be in attendance at the regional public meeting. There will be an opportunity for public comment on each of these international issues. The length of the meeting may be adjusted based on the progress of the discussions.

Please be reminded that NMFS expects members of the public to conduct themselves appropriately for the duration of the meeting. At the beginning of the public comment session, an explanation of the ground rules will be provided (e.g., alcohol in the meeting room is prohibited, speakers will be called to give their comments in the order in which they registered to speak, each speaker will have an equal amount of time to speak, and speakers should not interrupt one another). The session will be structured so that all attending members of the public are able to comment, if they so choose, regardless of the degree of controversy of the subject(s). Those not respecting the ground rules will be asked to leave the meeting.

Special Accommodations

The meeting locations are physically accessible to people with disabilities. Requests for sign language interpretation or other auxiliary aids should be directed to Erika Carlsen at (301) 713–2276 at least 5 days prior to the meeting date.

Dated: July 29, 2003.

Bruce Morehead,

Acting Director, Office of Sustainable Fisheries, National Marine Fisheries Service.

[FR Doc. 03–19702 Filed 8–1–03; 8:45 am]

BILLING CODE 3510–22–S

DEPARTMENT OF COMMERCE

National Oceanic and Atmospheric Administration

[I.D. 072903B]

Pacific Fishery Management Council; Public Meeting

AGENCY: National Marine Fisheries Service (NMFS), National Oceanic and Atmospheric Administration (NOAA), Commerce.

ACTION: Notice of a public meeting.

SUMMARY: The Pacific Fishery Management Council's (Council) Scientific and Statistical Committee (SSC) Marine Reserves Subcommittee will hold a work session, which is open to the public.

DATES: The work session will be Monday, August 18, 2003 from 10 a.m. to 5 p.m.; Tuesday, August 19, 2003 from 8 a.m to 5 p.m.; and Wednesday, August 20, 2003 from 8 a.m. until business for the day is completed.

ADDRESSES: The work session will be held at the Pacific Fishery Management Council, 7700 NE Ambassador Place, Suite 200, Portland, OR 97220; telephone: (503) 820–2280, toll free: (866) 806–7204.

FOR FURTHER INFORMATION CONTACT: Mr. Dan Waldeck, Pacific Fishery Management Council; telephone: (503) 820–2280, toll free: (866) 806–7204.

SUPPLEMENTARY INFORMATION: At this meeting, the SSC Marine Reserves Subcommittee will evaluate the implications of marine reserves for fishery management, taking into consideration (1) reserve objectives and (2) uncertainties associated with both reserves and traditional fishery management. Initial descriptions of SSC expectations of marine reserve proposals submitted to the Council in terms of "real world" considerations, including items (1) and (2) above, will also be discussed. The preliminary recommendations of the subcommittee will be reviewed by the SSC at the September 2003 Council meeting.

The proposed agenda is as follows:

1. Introductions
2. Discussion and Approval of Agenda
3. Interaction Between Reserves and Traditional Fishery Management

A. Reserves as an "insurance policy" against uncertainties/errors in traditional fishery management

B. Reserves as a source of fishery benefits

C. Reserves as a source of ecosystem benefits (e.g., enhance biodiversity, protect habitat)

D. Reserves as an opportunity to advance scientific knowledge (e.g., of ecological functions, environmental versus anthropomorphic influences)

4. SSC Expectations Regarding Marine Reserve Proposals

A. Defining the objective, including description of why status quo does not achieve the objective

B. Identifying variables that measure reserve effects

C. Providing a reasonable basis for reserve design/size/location

D. Developing data collections and analyses to monitor progress toward achieving the objective

E. Identifying full range of alternatives for meeting the objective

F. Analyzing alternatives

G. Other (including procedural requirements)?

5. Subcommittee Recommendations to the Council
6. Research and Data Needs (Time Permitting)

Although nonemergency issues not contained in the meeting agenda may be discussed, those issues may not be the subject of formal action during this meeting. Action will be restricted to those issues specifically listed in this document and any issues arising after publication of this document that require emergency action under section 305(c) of the Magnuson-Stevens Fishery Conservation and Management Act, provided the public has been notified of the intent to take final action to address the emergency.

Special Accommodations

The meeting is physically accessible to people with disabilities. Requests for sign language interpretation or other auxiliary aids should be directed to Ms. Carolyn Porter at (503) 820–2280 at least 5 days prior to the meeting date.

Dated: July 29, 2003.

Richard W. Surdi,

Acting Director, Office of Sustainable Fisheries, National Marine Fisheries Service.

[FR Doc. 03–19701 Filed 8–1–03; 8:45 am]

BILLING CODE 3510–22–S

CONSUMER PRODUCT SAFETY COMMISSION

Submission for OMB Review; Comment Request—Flammability Standards for Clothing Textiles and Vinyl Plastic Film

AGENCY: Consumer Product Safety Commission.

ACTION: Notice.

SUMMARY: In the **Federal Register** of May 23, 2003 (68 FR 28198), the Consumer Product Safety Commission published a notice in accordance with

provisions of the Paperwork Reduction Act of 1995 (44 U.S.C. Chapter 35) to announce the agency's intention to seek an extension of approval of a collection of information in regulations implementing the flammability standards for clothing textiles and vinyl plastic film. The regulations prescribe requirements for testing and recordkeeping by persons and firms issuing guaranties of garments, fabrics, and related materials subject to the Standard for the Flammability of Clothing Textiles (16 CFR part 1610) and the Standard for the Flammability of Vinyl Plastic Film (16 CFR part 1611). No comments were received in response to that notice. By publication of this notice, the Commission announces that it has submitted to the Office of Management and Budget (OMB) a request for an extension of approval of those collections of information without change for three years from the date of approval by OMB.

Additional Information About the Request for Extension of Approval of the Collection of Information

Agency address: Consumer Product Safety Commission, Washington, DC 20207.

Title of information collection: Standard for the Flammability of Clothing Textiles, 16 CFR part 1610; Standard for the Flammability of Vinyl Plastic Film, 16 CFR part 1611.

Type of request: Extension of approval without change.

General description of respondents: Manufacturers and importers of garments, fabrics, and related materials subject to the flammability standards for clothing textiles and vinyl plastic film.

Estimated number of respondents: 1000.

Estimated average number of hours per respondent: 101.6 per year.

Estimated number of hours for all respondents: 101,600 per year.

Estimated cost of collection for all respondents: $2,688,336.

Comments: Comments on this request for extension of approval of information collection requirements should be submitted by September 3, 2003 to (1) The Office of Information and Regulatory Affairs, Attn: OMB Desk Officer for CPSC, Office of Management and Budget, Washington DC 20503; telephone: (202) 395–7340, and (2) the Office of the Secretary, Consumer Product Safety Commission, Washington, DC 20207. Written comments may also be sent to the Office of the Secretary by facsimile at (301) 504–0127 or by e-mail at *cpsc-os@cpsc.gov.*

Copies of this request for extension of the information collection requirements and supporting documentation are available from Linda Glatz, management and program analyst, Office of Planning and Evaluation, Consumer Product Safety Commission, Washington, DC 20207; telephone: (301) 504–7671.

Dated: July 24, 2003.

Todd A. Stevenson,

Secretary, Consumer Product Safety Commission.

[FR Doc. 03–19737 Filed 8–1–03; 8:45 am]

BILLING CODE 6355–01–P

DEFENSE NUCLEAR FACILITIES SAFETY BOARD

Sunshine Act Meeting

Pursuant to the provisions of the "Government in the Sunshine Act" (5 U.S.C. 552b), notice is hereby given of the Defense Nuclear Facilities Safety Board's (Board) meeting described below. The Board will also conduct a series of public hearings pursuant to 42 U.S.C. 2286b and invites any interested persons or groups to present any comments, technical information, or data concerning safety issues related to the matters to be considered.

TIME AND DATE OF MEETING: 9–12 a.m.; September 10, 2003.

PLACE: Defense Nuclear Facilities Safety Board, Public Hearing Room, 625 Indiana Avenue, NW., Suite 300, Washington, DC 20004–2001. Additionally, as a part of the Board's E-Government initiative, the meeting will be presented live through Internet video streaming. A link to this presentation will be available on the home page of the Board's Web site (*www.dnfsb.gov*).

STATUS: Open. While the Government in the Sunshine Act does not require that the scheduled discussion be conducted in a meeting, the Board has determined that an open meeting in this specific case furthers the public interests underlying both the Sunshine Act and the Board's enabling legislation.

MATTERS TO BE CONSIDERED: The Board is reviewing the Department of Energy's (DOE) current oversight and management of the contracts and contractors it relies upon to accomplish the mission assigned to DOE under the Atomic Energy Act of 1954, as amended. We will focus on what impact, if any, DOE's new initiatives may have upon assuring adequate protection of the health and safety of the public and workers at DOE's defense nuclear facilities. Over the next several months, we will conduct a series of public meetings to collect information needed to understand and address any health or safety concerns that may require Board Action. This will include, but is not limited to, presentations by DOE and the National Nuclear Security Administration (NNSA) to explain their contract management and oversight initiatives; presentations by federal and industry experts in contracting for essential and high risk government services; and possibly further presentations by DNFSB staff.

The Board has identified several key areas that will be better examined in a public meeting. In the September 10th meeting, the Board will hear from representatives from the Nuclear Regulatory Commission (NRC), the National Aeronautics and Space Administration (NASA), the commercial nuclear sector, and the aerospace industry. The information gathered at that time will explore federal contract management and oversight experience in various organizations and will provide relevant reference experience. In subsequent public meetings, the Board will explore in more depth federal management and oversight policies being developed by DOE and NNSA for defense nuclear facilities. DOE and NNSA will be invited to discuss their new approaches to contract reform, contractor self-assessment, and federal oversight. The public hearing portion is independently authorized by 42 U.S.C. 2286b.

FOR FURTHER INFORMATION CONTACT: Kenneth M. Pusateri, General Manager, Defense Nuclear Facilities Safety Board, 625 Indiana Avenue, NW., Suite 700, Washington, DC 20004–2901, (800) 788–4016. This is a toll-free number.

SUPPLEMENTARY INFORMATION: Requests to speak at the hearing may be submitted in writing or by telephone. We ask that commentators describe the nature and scope of their oral presentation. Those who contact the Board prior to close of business on September 9, 2003, will be scheduled for time slots, beginning at approximately 11:30 a.m. The Board will post a schedule for those speakers who have contacted the Board before the hearing. The posting will be made at the entrance to the Public Hearing Room at the start of the 9 a.m. meeting.

Anyone who wishes to comment or provide technical information or data may do so in writing, either in lieu of, or in addition to, making an oral presentation. The Board Members may question presenters to the extent deemed appropriate. Documents will be accepted at the meeting or may be sent to the Defense Nuclear Facilities Safety Board's Washington, DC, office. The

Board will hold the record open until October 10, 2003, for the receipt of additional materials. A transcript of the meeting will be made available by the Board for inspection by the public at the Defense Nuclear Facilities Safety Board's Washington office and at DOE's public reading room at the DOE Federal Building, 1000 Independence Avenue, SW., Washington, DC 20585.

The Board specifically reserves its right to further schedule and otherwise regulate the course of the meeting and hearing, to recess, reconvene, postpone, or adjourn the meeting and hearing, conduct further reviews, and otherwise exercise its power under the Atomic Energy Act of 1954, as amended.

John T. Conway,

Chairman.

[FR Doc. 03–19957 Filed 7–31–03; 3:54 pm]

BILLING CODE 3670–01–P

DEPARTMENT OF EDUCATION

Submission for OMB Review; Comment Request

AGENCY: Department of Education.

SUMMARY: The Leader, Regulatory Information Management Group, Office of the Chief Information Officer invites comments on the submission for OMB review as required by the Paperwork Reduction Act of 1995.

DATES: Interested persons are invited to submit comments on or before September 3, 2003.

ADDRESSES: Written comments should be addressed to the Office of Information and Regulatory Affairs, Attention: Karen Lee, Desk Officer, Department of Education, Office of Management and Budget, 725 17th Street, NW., Room 10235, New Executive Office Building, Washington, DC 20503 or should be electronically mailed to the Internet address *Karen_F._Lee@omb.eop.gov*.

SUPPLEMENTARY INFORMATION: Section 3506 of the Paperwork Reduction Act of 1995 (44 U.S.C. chapter 35) requires that the Office of Management and Budget (OMB) provide interested Federal agencies and the public an early opportunity to comment on information collection requests. OMB may amend or waive the requirement for public consultation to the extent that public participation in the approval process would defeat the purpose of the information collection, violate State or Federal law, or substantially interfere with any agency's ability to perform its statutory obligations. The Leader, Regulatory Information Management Group, Office of the Chief Information Officer, publishes that notice containing proposed information collection requests prior to submission of these requests to OMB. Each proposed information collection, grouped by office, contains the following: (1) Type of review requested, *e.g.*, new, revision, extension, existing or reinstatement; (2) Title; (3) Summary of the collection; (4) Description of the need for, and proposed use of, the information; (5) Respondents and frequency of collection; and (6) Reporting and/or Recordkeeping burden. OMB invites public comment.

Dated: July 29, 2003.

Angela C. Arrington,

Leader, Regulatory Information Management Group, Office of the Chief Information Officer.

Institute of Education Sciences

Type of Review: New.

Title: National Assessment of Education Progress: 2004 Field Test and 2005 Full Scale Study, Math and Science.

Frequency: Annually.

Affected Public: State, local or Tribal Gov't, SEAs or LEAs.

Reporting and Recordkeeping Hour Burden:

Responses: 44,290.

Burden Hours: 11,144.

Abstract: In 2004, the National Assessment of Educational Progress will field test materials for the 2005 full-scale assessment on science. The materials contained in this clearance package are the questionnaires for students, teachers, and school administrators.

Requests for copies of the submission for OMB review; comment request may be accessed from *http://edicsweb.ed.gov*, by selecting the ''Browse Pending Collections'' link and by clicking on link number 2281. When you access the information collection, click on ''Download Attachments'' to view. Written requests for information should be addressed to Vivian Reese, Department of Education, 400 Maryland Avenue, SW., Room 4050, Regional Office Building 3, Washington, DC 20202–4651 or to the e-mail address *Vivan.Reese@ed.gov*. Requests may also be electronically mailed to the Internet address *OCIO_RIMG@ed.gov* or faxed to 202–708–9346. Please specify the complete title of the information collection when making your request.

Comments regarding burden and/or the collection activity requirements should be directed to Katrina Ingalls at her e-mail address *Katrina.Ingalls@ed.gov*. Individuals who use a telecommunications device for the deaf (TDD) may call the Federal Information Relay Service (FIRS) at 1–800–877–8339.

[FR Doc. 03–19690 Filed 8–1–03; 8:45 am]

BILLING CODE 4000–01–P

DEPARTMENT OF EDUCATION

Recognition of Accrediting Agencies, State Agencies for the Approval of Public Postsecondary Vocational Education, and State Agencies for the Approval of Nurse Education

AGENCY: National Advisory Committee on Institutional Quality and Integrity, Department of Education (The Advisory Committee).

What Is the Purpose of This Notice?

The purpose of this notice is to invite written comments on accrediting agencies and State approval agencies whose applications to the Secretary for initial or renewed recognition or whose interim reports will be reviewed at the Advisory Committee meeting to be held on December 8–9, 2003.

Where Should I Submit My Comments?

Please submit your written comments by September 18, 2003 to Carol Griffiths, Chief, Accrediting Agency Evaluation, Accreditation and State Liaison. You may contact her at the U.S. Department of Education, room 7105, MS 8509, 1990 K Street, NW., Washington, DC 20006, telephone: (202) 219–7011. Individuals who use a telecommunications device for the deaf (TDD) may call the Federal Information Relay Service at 1–800–877–8339.

What Is the Authority for the Advisory Committee?

The National Advisory Committee on Institutional Quality and Integrity is established under Section 114 of the Higher Education Act (HEA), as amended, 20 U.S.C. 1011c. One of the purposes of the Advisory Committee is to advise the Secretary of Education on the recognition of accrediting agencies and State approval agencies.

Will This Be My Only Opportunity To Submit Written Comments?

Yes, this notice announces the only opportunity you will have to submit written comments. However, a subsequent **Federal Register** notice will announce the meeting and invite individuals and/or groups to submit requests to make oral presentations before the Advisory Committee on the agencies that the Committee will review. That notice, however, does not offer a second opportunity to submit written comment.

What Happens to the Comments That I Submit?

We will review your comments, in response to this notice, as part of our evaluation of the agencies' compliance with the Secretary's Criteria for Recognition of Accrediting Agencies and State Approval Agencies. The Criteria are regulations found in 34 CFR Part 602 (for accrediting agencies) and in 34 CFR Part 603 (for State approval agencies) and are found at the following site: *http://www.ed.gov/offices/OPE/accreditation.*

We will also include your comments with the staff analyses we present to the Advisory Committee at its December 2003 meeting. Therefore, in order for us to give full consideration to your comments, it is important that we receive them by September 18, 2003. In all instances, your comments about agencies seeking initial or continued recognition must relate to the Criteria for Recognition. In addition, your comments for any agency whose interim report is scheduled for review must relate to the issues raised and the Criteria for Recognition cited in the Secretary's letter that requested the interim report.

What Happens to Comments Received After the Deadline?

We will review any comments received after the deadline. If such comments, upon investigation, reveal that the accrediting agency is not acting in accordance with the Criteria for Recognition, we will take action either before or after the meeting, as appropriate.

What Agencies Will the Advisory Committee Review at the Meeting?

The Secretary of Education recognizes accrediting agencies and State approval agencies for public postsecondary vocational education and nurse education if the Secretary determines that they meet the Criteria for Recognition. Recognition means that the Secretary considers the agency to be a reliable authority as to the quality of education offered by institutions or programs it accredits that are encompassed within the scope of recognition he grants to the agency. The following agencies will be reviewed during the December 2003 meeting of the Advisory Committee:

Nationally Recognized Accrediting Agencies

Petitions for Renewal of Recognition

1. Accrediting Bureau of Health Education Schools (Current scope of recognition: The accreditation of private, postsecondary allied health education institutions and institutions that offer predominantly allied health programs, private medical assistant programs, and public and private medical laboratory technician programs leading to the Associate of Applied Science and the Associate of Occupational Science degrees.)

Interim Reports (An interim report is a follow-up report on an accrediting agency's compliance with specific criteria for recognition that was requested by the Secretary when the Secretary granted renewed recognition to the agency.)

1. Accrediting Commission on Education for Health Services Administration
2. American Board of Funeral Service Education
3. Association of Advanced Rabbinical and Talmudic Schools
4. National Council for Accreditation of Teacher Education

Progress Reports

1. Southern Association of Colleges and Schools, Commission on Colleges (This is a report on the agency's implementation of its new standards).
2. Western Association of Schools and Colleges, Accrediting Commission for Schools (This is a report on the agency's action plan for coming into compliance with criteria for recognition).

State Agencies Recognized for the Approval of Public Postsecondary Vocational Education

Petitions for Renewal of Recognition

1. Missouri State Board of Education (Current scope of recognition: The approval of public, postsecondary vocational education in the state of Missouri)

At its June 2003 meeting, the Advisory Committee recommended that review of this agency's petition for continued recognition be deferred until the Committee's December 2003 meeting.

Interim Reports

2. New York Board of Regents (Public Postsecondary Vocational Education Unit)

State Agencies Recognized for the Approval of Nurse Education

Interim Reports

1. North Dakota Board of Nursing

Where Can I Inspect Petitions and Third-Party Comments Before and After the Meeting?

All petitions and those third-party comments received in advance of the meeting, will be available for public inspection and copying at the U.S. Department of Education, room 7105, MS 8509, 1990 K Street, NW., Washington, DC 20006, telephone (202) 219–7011 between the hours of 8 a.m. and 3 p.m., Monday through Friday, until November 14, 2003. They will be available again after the December 8–9 Advisory Committee meeting. An appointment must be made in advance of such inspection or copying.

How May I Obtain Electronic Access to This Document?

You may view this document, as well as all other Department of Education documents published in the **Federal Register**, in text or Adobe Portable Document Format (PDF) on the Internet at the following site: *http://www.ed.gov/legislation/FedRegister*

To use PDF you must have Adobe Acrobat Reader, which is available free at this site. If you have questions about using PDF, call the U.S. Government Printing Office (GPO), toll free, at 1–888–293–6498; or in the Washington, DC, area at (202) 512–1530.

Note: The official version of this document is the document published in the **Federal Register**. Free Internet access to the official edition of the **Federal Register** and the Code of Federal Regulations is available on GPO Access at: *http://www.access.gpo.gov/nara/index.html*

Authority: 5 U.S.C. Appendix 2.

Sally L. Stroup,
Assistant Secretary for Postsecondary Education.

[FR Doc. 03–19723 Filed 8–1–03; 8:45 am]

BILLING CODE 4000–01–U

DEPARTMENT OF ENERGY

Bonneville Power Administration

Electrical Interconnection of the Summit/Westward Project

AGENCY: Bonneville Power Administration (BPA), Department of Energy (DOE).

ACTION: Notice of availability of Record of Decision (ROD).

SUMMARY: This notice announces the availability of the ROD to offer contract terms for interconnection of the proposed Summit/Westward Project into the Federal Columbia River Transmission System at BPA's Allston

Substation. This decision is consistent with BPA's Business Plan Final Environmental Impact Statement (DOE/EIS–0183, June 1995) and the Business Plan ROD (August 1995). The project is proposed by Westward Energy, LLC, and involves construction and operation of a 520-megawatt natural-gas-fired, combined-cycle generating facility to be located in Columbia County, Oregon, about 4.5 miles north of Clatskanie, Oregon.

ADDRESSES: Copies of the ROD and EIS may be obtained by calling BPA's toll-free document request line, 1–800–622–4520. The ROD and EIS Summary are also available on our Web site, *www.efw.bpa.gov*.

FOR FURTHER INFORMATION, CONTACT: Dawn Boorse, Bonneville Power Administration—KEC–4, P.O. Box 3621, Portland, Oregon, 97208–3621; toll-free telephone number 1–800–282–3713; direct telephone number 503–230–5678; fax number 503–230–5699; or e-mail *drboorse@bpa.gov*.

Issued in Portland, Oregon, on July 25, 2003.

Stephen J. Wright,

Administrator and Chief Executive Officer.

[FR Doc. 03–19709 Filed 8–1–03; 8:45 am]

BILLING CODE 6450–01–U

DEPARTMENT OF ENERGY

Federal Energy Regulatory Commission

[Docket Nos. EL02–111–000 and EL03–212–000]

Before Commissioners: Pat Wood III, Chairman; William L. Massey, and Nora Mead Brownell; Order on Initial Decision

Issued: July 23, 2003.

Midwest Independent Transmission System Operator, Inc.; PJM Interconnection, L.L.C. and all Transmission Owners (including the entities identified below); Union Electric Company; Central Illinois Public Service Company; Appalachian Power Company; Columbus Southern Power Company; Indiana Michigan Power Company; Kentucky Power Company; Kingsport Power Company; Ohio Power Company; Wheeling Power Company; Michigan Electric Transmission Company; Dayton Power and Light Company; Commonwealth Edison Company; Commonwealth Edison Company of Indiana, Inc.; American Transmission Systems, Inc.; Illinois Power Company; Northern Indiana Public Service Company; Virginia Electric and Power Company; IES Utilities, Inc.; Interstate Power Company; Aquila, Inc. (formerly UtiliCorp United, Inc.); PSI Energy, Inc.; Union Light Heat & Power Company; Dairyland Power Cooperative; Great River Energy; Hoosier Energy Rural Electric Cooperative; Indiana Municipal Power Agency; Indianapolis Power & Light Company; Louisville Gas & Electric Company; Kentucky Utilities Company; Lincoln Electric (Neb.) System; Minnesota Power, Inc. and its subsidiary Superior Water, Light & Power Company; Montana-Dakota Utilities; Northwestern Wisconsin Electric Company; Otter Tail Power Company; Southern Illinois Power Cooperative; Southern Indiana Gas & Electric Cooperative; Southern Minnesota Municipal Power Agency; Sunflower Electric Power Corporation; Wabash Valley Power Association, Inc.; Wolverine Power Supply Cooperative; International Transmission Company; Alliant Energy West; Xcel Energy Services, Inc.; MidAmerican Energy Company; Corn Belt Power Corporation; Allegheny Electric Cooperative, Inc.; Atlantic City Electric Company; Baltimore Gas & Electric Company; Delmarva Power & Light Company; Jersey Central Power & Light Company; Metropolitan Edison Company; PECO Energy Company; Pennsylvania Electric Company; PPL Electric Utilities Corporation; Potomac Electric Power Company; UGI Utilities, Inc.; Allegheny Power; Carolina Power & Light Company; Central Power & Light Company; Conectiv; Detroit Edison Company; Duke Power Company; Florida Power & Light Company; GPU Energy; Northeast Utilities Service Company; Old Dominion Electric Cooperative; Public Service Company of Colorado; Public Service Electric & Gas Company; Public Service Company of Oklahoma; Rockland Electric Company; South Carolina Electric & Gas Company; Southwestern Electric Power Company; Cincinnati Gas & Electric Company; Missouri Public Service; WestPlains Energy; Cleco Corporation; Kansas Power & Light Company; OG+E Electric Services; Southwestern Public Service Company; Empire District Electric Company; Western Resources; Kansas Gas & Electric Co.; Ameren Services Company on behalf of: Union Electric Company, Central Illinois Public Service Company; American Electric Power Service Corporation on behalf of: Appalachian Power Company, Columbus Southern Power Company, Indiana Michigan Power Company, Kentucky Power Company, Kingsport Power Company, Ohio Power Company, Wheeling Power Company; Dayton Power and Light Company; Exelon Corporation on behalf of: Commonwealth Edison Company, Commonwealth Edison Company of Indiana, Inc.; FirstEnergy Corporation on behalf of: American Transmission Systems, Inc., Cleveland Electric Illuminating Power Company, Ohio Edison Company, Pennsylvania Power Company, Toledo Edison Company; Illinois Power Company; and Northern Indiana Public Service Company.

1. This order addresses an initial decision issued in the above proceeding, where the Presiding Judge determined that he had no precedential authority that would permit him to eliminate the Regional Through and Out Rates (RTORs) between the expanded Midwest Independent Transmission System Operator, Inc. (Midwest ISO) and expanded PJM Interconnection, L.L.C. (PJM) under the circumstances of this case. The order disagrees with the Presiding Judge's finding and concludes that the Midwest ISO and PJM RTORs, when applied to transactions sinking within the proposed Midwest ISO/PJM footprint, are unjust and unreasonable, and directs PJM and Midwest ISO to make a compliance filing within 30 days eliminating these RTORs effective November 1, 2003.

2. The order also finds that the through and out rates under the tariffs of certain individual former Alliance Companies may be unjust, unreasonable or unduly discriminatory or preferential and initiates an investigation and hearing in Docket No. EL03–212–000 under section 206 of the Federal Power Act (FPA), 16 U.S.C. 824e (2000) regarding these rates. The Commission will conduct a "paper" hearing to determine whether such rates are just, reasonable and not unduly discriminatory or preferential and thus provides parties with an opportunity to explain why the rates are or are not unjust, unreasonable or unduly discriminatory or preferential on or before August 15, 2003.

3. The order also states that the Commission will entertain section 205 filings to establish transitional cost recovery mechanisms once the RTORs are eliminated, and provides guidance in this regard.

Background

July 31 Order

4. On July 31, 2002, the Commission issued an order [1] that conditionally accepted the compliance filings of the former Alliance Companies, under which they proposed to join either Midwest ISO or PJM, as consistent with Order No. 2000,[2] subject to satisfactory compliance with certain conditions, summarized as follows: (1) That a single market across the two Regional Transmission Organizations (RTO) must be implemented by October 1, 2004; (2) that National Grid USA (National Grid) participates in both Midwest ISO as GridAmerica and in PJM, and performs

[1] *See* Alliance Companies, *et al.*, 100 FERC ¶ 61,137 (2002) (July 31 Order).

[2] Regional Transmission Organizations, Order No. 2000, 65 FR 809 (January 6, 2000), FERC Stats. & Regs., Regulations Preambles July 1996–December 2000 ¶ 31,089 (1999), *order on reh'g*, Order No. 2000–A, 65 FR 12088 (March 8, 2000), FERC Stats. & Regs., Regulations Preambles July 1996–December 2000 ¶ 31,092 (2000), *affirmed sub nom. Public Utility District No. 1 Snohomish County Washington, et al.*, v. *FERC*, 272 F.3d 607 (D.C. Cir. 2002) (Order No. 2000).

the same functions, consistent with the allocation of functions to independent transmission companies (ITCs) provided in the April 25 Order [3] and *TRANSLink*,[4] in both RTOs for Day One operations; (3) that there be pro forma agreements under the respective tariffs of Midwest ISO and PJM that provide for participation of ITCs consistent with the delegation of functions provided for in the April 25 Order and *TRANSLink*; (4) that the agreement to form an ITC between National Grid, American Electric Power Service Corporation, on behalf of certain of its public utility affiliates [5] (collectively, AEP), Commonwealth Edison Company and Commonwealth Edison Company of Indiana, Inc. (collectively, ComEd), Dayton Power and Light Company (DP&L), and PJM must be filed within 30 days of the July 31 Order; (5) that the North American Electric Reliability Council (NERC) must approve the Reliability Plans pursuant to which PJM and Midwest ISO will coordinate their operations under the new configuration; (6) that a solution addressing the through and out rates between Midwest ISO and PJM must be developed; (7) that certain of the former Alliance Companies seeking to join PJM, along with PJM and Midwest ISO, provide a solution which will effectively hold utilities in Wisconsin and Michigan harmless from any loop flows or congestion that results from the proposed configuration; (8) that PJM and Midwest ISO must each file a statement agreeing to the conditions within 15 days of the July 31 Order, an implementation plan for achieving a common market by October 1, 2004, within 45 days, and frequent progress reports thereafter; and (9) that Commission Staff participate in the process.[6]

5. The Commission explained that the former Alliance Companies' choices, standing alone, appeared to produce unjust and unreasonable rates, terms and conditions for transmission services, but that these conditions would ensure just and reasonable rates, terms, and conditions for transmission services. The July 31 Order also noted that these conditions reflected areas which NERC concluded needed to be addressed, as well as commitments made by the parties in order to further the goal of reaching a region-wide common market as soon as possible.[7]

6. The Commission particularly found that one of the primary obstacles to RTO formation has been rate pancaking for transactions crossing RTO borders, and that both Midwest ISO and PJM agreed that this was an issue. The Commission stated that, in light of the former Alliance Companies' RTO choices and in view of the comments, the resolution of inter-RTO rates was fundamental to its decision to accept the choices of Illinois Power, ComEd, and AEP to join PJM, and that resolving inter-RTO rates was fundamental to establishing a single common market. Therefore, the July 31 Order also instituted an investigation and hearing of inter-RTO rates under Section 206 of the FPA before an administrative law judge in Docket No. EL02–111–000, with regard to the rates for through and out service in the Midwest ISO/PJM region and with respect to the protocols relating to the distribution of revenues associated with such through and out service.[8]

7. The Commission also stated that it was mindful that any solution may need to be revised once a common market across the Midwest ISO/PJM region is fully developed, and would be subject to the Commission's final determination on Standard Market Design in Docket No. RM01–12–000.[9] In addition, we stated that any such solution must result in rates that are designed in a reasonable fashion and do not favor participants in one RTO over those in the other. We noted that, while we were instituting a Section 206 proceeding, we nevertheless encouraged Midwest ISO and PJM to develop a solution to eliminate rate pancaking between the organizations on their own as expeditiously as possible, and we allowed them a period of time to do so.

Order on Rehearing of the July 31 Order

8. In the order on rehearing and clarification of the July 31 Order,[10] the Commission denied rehearing of the Commission's findings that the former Alliance Companies' RTO choices could not be accepted without the conditions set forth in the July 31 Order. The Commission stated that, given the record in this proceeding, without the conditions ordered the choices of some of the former Alliance Companies to join PJM would result in inappropriate RTO configuration. Moreover, the Commission found that, given the locations of the former Alliance Companies and their links with other neighboring utilities, outright acceptance of their RTO choices, without any conditions, would not have been just and reasonable. In this regard, the Commission stated that, for example, given the locations of the New PJM Companies [11] and Illinois Power [12] in the heart of the Midwest ISO region and the tight links between these companies and their neighboring utilities in the Midwest ISO region, we could not accept their joining PJM as just and reasonable without the conditions we adopted.[13]

9. The Commission disagreed with the parties' contention that the record did not support the July 31 Order's conditions. We stated that the record in this proceeding indicated that the RTO choices, as proposed (and as accepted albeit with conditions) were problematic when considered in light of Order No. 2000. The Commission found that the proposed RTO choices and

[3] Alliance Companies, *et al.*, 99 FERC ¶ 61,105 (2002) (April 25 Order).

[4] TRANSLink Transmission Company, L.L.C., *et al.*, 99 FERC ¶ 61,106 (2002) (*TRANSLink*).

[5] Appalachian Power Company, Columbus Southern Power Company, Indiana Michigan Power Company, Kentucky Power Company, Kingsport Power Company, Ohio Power Company, Wheeling Power Company.

[6] *See* July 31 Order at P 35–57.

[7] *Id.* at P 35–36.

[8] *Id.* at P 49–50.

[9] Remedying Undue Discrimination Through Open Access Transmission Service and Standard Electricity Market Design, Notice of Proposed Rulemaking, FERC Stats & Regs. ¶ 32,563 (2002) (SMD NOPR).

[10] Alliance Companies, *et al.*, 103 FERC ¶ 61,274 (2003) (Rehearing Order).

[11] On December 11, 2002, in Docket No. ER03–262–000, AEP, ComEd, DP&L, and Virginia Electric Power Company (collectively, the New PJM Companies) and PJM filed an application under Section 205 of the FPA to include the New PJM Companies as transmission owners within PJM. On April 1, 2003, the Commission accepted the filing related to ComEd's and AEP's joining PJM, effective as of the date of the transfer of control of AEP's and ComEd's facilities to PJM. *See* American Electric Power Service Corporation, *et al.*, 103 FERC ¶ 61,008 (2003); *see also* American Electric Power Service Corporation, 103 FERC ¶ 61,009 (2003).

We also note that the Virginia Legislature recently passed a bill that prohibits Virginia utilities (which would include AEP) from joining an RTO before July 1, 2004, and requires them to obtain prior approval form the Virginia State Corporation Commission. In contrast, on March 14, 2003, the Pennsylvania Public Utility Commission, the Michigan Public Service Commission, and the Ohio Public Utilities Commission filed a motion in Docket No. EC98–40–000, *et al.*, requesting, among other things, that the Commission direct AEP to join an established RTO, as earlier required in that proceeding.

[12] In the Rehearing Order, we noted that, in an application pending before the Commission in Docket No. EC03–30–000, *et al.*, Illinois Power has proposed to transfer its transmission system to Illinois Electric Transmission Company, LLC (IETC), an indirect subsidiary of Trans-Elect, Inc. As part of that proposed transaction, IETC commits to make all of the necessary filings with the Commission to facilitate transfer of functional control of the transmission system to Midwest ISO. Such commitment is contingent on the sale to IETC, which has yet to be authorized by the Commission or consummated. We note that Illinois Power has terminated its Asset Purchase Agreement with Trans-Elect, Inc and Illinois Electric Transmission Co., LLC. *See* Illinois Power's Company Filing (Form 8K) with the Securities and Exchange Commission (July 9, 2003), available at *http://www.sec.gov*.

[13] Rehearing Order at P 20–21.

resulting configuration, without conditions, would frustrate the realization of the goals of RTO formation such as resolution of loop flow issues, effective management of congestion, and enhanced reliability and efficiency.[14]

Initial Decision

10. On March 31, 2003, in *Midwest Independent System Operator, et al.*, 102 FERC ¶ 63,049 (2003) (Initial Decision), the Presiding Judge issued his Initial Decision. The Presiding Judge found no precedential authority that would permit him to eliminate the RTORs between Midwest ISO and PJM under the circumstances of this proceeding, and he declined to do so. The Presiding Judge added that if in a change in policy the Commission were to order it, he would recommend that the Commission adopt, without requiring the filing of new rate cases, a mechanism such as one of the Seams Elimination Charge/Cost Adjustment/Assignment (SECA) proposals by the parties to prevent cost shifting between customers of the two RTOs. Furthermore, the Presiding Judge stated that the Commission should decide whether to consider the impact and equities vis-a-vis retail rate caps when it fashions the SECA.[15]

11. The Presiding Judge found that eliminating the RTORs without a SECA will improperly shift costs from Midwest ISO's native load to PJM's native load.[16] The Presiding Judge also found that if the RTORs are eliminated, a SECA could prevent unwarranted cost shifts between the RTOs without violating any rules against retroactive ratemaking.[17]

12. The Presiding Judge also recommended that the SECA should not be phased out until another method is placed into effect to prevent cost shifting, and also stated that the Michigan and Wisconsin customers should be permitted to opt out of the SECA and continue to be subject to the PJM RTOR. In addition, the Presiding Judge stated that the SECA should be calculated using 2002 as the test year rather than 2001, and that the starting period for any SECA should be after a final Commission order, allowing enough time for the filing of compliance filings. The Presiding Judge added that the SECA should replace only through and out charges on transactions that sink in either the expanded PJM or the expanded Midwest ISO and either source in or wheel through the other RTO. Finally, the Presiding Judge stated that the Commission should decide, as a matter of policy, whether a SECA should be adopted for each pricing zone, or alternatively, whether there should be a sub-zone option that the entities within a pricing zone can choose.[18]

Discussion

Procedural Matter

13. On April 17, 2003, the Wisconsin Commission filed a motion to intervene out-of-time. The Wisconsin Commission states that, since it participated in the proceeding in Docket No. EL02–65–000, and the instant proceeding was instituted in Docket No. EL02–65–000, it assumed it was unnecessary to separately intervene in the instant proceeding. The Wisconsin Commission continues that, while it monitored the hearing in this proceeding and felt it unnecessary to actively participate, the Initial Decision raised issues that required the filing of a brief on exceptions in order to protect its regulatory interest in matters pertaining to Midwest ISO.

14. On May 7, 2003, the New PJM Companies and PECO filed an answer opposing the Wisconsin Commission's motion to intervene and asking that the Commission deny the Wisconsin Commission's request and strike its brief on exceptions. They contend that the Wisconsin Commission chose to ''wait and see'' what transpired in the hearing and the outcome of the Presiding Judge's decision before seeking intervention and filing a brief on exceptions, and that the Wisconsin Commission has not demonstrated good cause for its request and granting the intervention would unduly burden the parties.

15. On May 12, 2003, Detroit Edison Company (Detroit Edison) filed an answer opposing the New PJM Companies and PECO's motion to strike. Detroit Edison claims that no party is unduly prejudiced because parties will have an opportunity to respond to the Wisconsin Commission in briefs opposing exceptions. Detroit Edison also asserts that the Wisconsin Commission is the only party representing ratepayers in Wisconsin.

16. On May 13, 2003, the Wisconsin Public Service Corp. (WPSC) filed an answer opposing the New PJM Companies and PECO's motion to strike, arguing that the Wisconsin Commission has regulatory jurisdiction for the retail ratepayers of Wisconsin whose interests will be significantly impacted by the Commission's resolution of the issues in this proceeding.

17. On May 14, 2003, the Wisconsin Commission filed an answer to the New PJM Companies and PECO's motion to strike. The Wisconsin Commission asks that the Commission deny the motion because: (1) The Commission did not set a deadline for interventions; (2) the movants filed their answer and motion to strike out of time; (3) the Commission should construe the Wisconsin Commission's motion to intervene as a timely filed notice of intervention; and (4) the Commission should not strike its brief on exceptions because its motion to intervene satisfies the standards for late intervention.

18. Under Rule 214 of the Commission's Rules of Practice and Procedure,[19] we will deny the Wisconsin Commission's untimely, opposed motion to intervene. Under the facts presented, we do not believe that it would be in the public interest to permit the Wisconsin Commission's motion to intervene in this proceeding at this late date. We think, however, that participation as amicus curiae would serve the purposes of the Wisconsin Commission to carry out its responsibilities and would contribute to our consideration of the issues in this case. Therefore, we will deny the Wisconsin Commission's request for intervention but we will permit it to file its brief and deny New PJM Companies and PECO's motion to strike.[20]

The Justness and Reasonableness of the RTORs

Presiding Judge's Ruling

19. The Presiding Judge claimed that there was no precedential authority that would permit a finding, under the circumstances of this proceeding, that the RTORs between the expanded PJM and the expanded Midwest ISO are unjust and unreasonable. He concluded that, while the Commission has encouraged the elimination of rate pancaking between RTOs, it has never required it.

20. The Presiding Judge stated that, if the proposed incorporation of the New PJM Companies into PJM would create seams that result in islanding a significant portion of the Midwest ISO load so that it would have to pay pancaked rates to have power transmitted to it from generation

[14] Rehearing Order at P 24–30.

[15] Initial Decision at P 7, 101.

[16] Initial Decision at P 68–86.

[17] Initial Decision at P 87–90.

[18] Initial Decision at P 91–100.

[19] 18 CFR 385.713(d)(2) (2003).

[20] *See* Transwestern Pipeline Company, 35 FPC 334, 335 (1966); *see also* Transcontinental Gas Pipe Line, 88 FERC ¶ 61,155 at 61,521 (1999); Texas Eastern Transmission Corporation, 88 FERC ¶ 61,167 at 61,559 (1999).

elsewhere in Midwest ISO, then the RTORs would be unjust and unreasonable. However, the Presiding Judge found that the choices of the New PJM Companies to join PJM did not create any new seams because seams already exist between Midwest ISO and New PJM Companies; rate pancaking currently exists across the seams between the individual former Alliance Companies joining PJM and Midwest ISO because the Midwest ISO members are currently required to pay through and out rates to the individual New PJM Companies and Illinois Power under their individual-company OATTs. The Presiding Judge noted that, after these companies join PJM, the Midwest ISO members will pay the PJM RTOR instead of the individual-company through and out rates, and he found no evidence that replacing the individual-company through and out rates with the PJM RTOR was unjust and unreasonable.

21. However, while the Presiding Judge stated that he could not find the RTORs unjust and unreasonable under the circumstances, he did find that no credible evidence was presented that would suggest that rate pancaking across the proposed border is any less detrimental to short-term efficiency than rate pancaking in general (*i.e.*, rate pancaking within an RTO). He also rejected arguments that the RTORs were a reasonable basis for reflecting a distance factor in rates, so that long-term efficiency is enhanced. He found that the anomalous seam configuration that would exist between Midwest ISO and PJM argues very persuasively against that and suggested that, if a distance factor should be incorporated into transmission charges, it should be done directly, not imperfectly reflected in the seams charges.[21]

Briefs on Exceptions

22. Many parties except to the Presiding Judge's decision to not eliminate the existing RTORs due to a lack of precedential authority, and/or his conclusion that the choice of the New PJM Companies to join PJM did not create new and irrational seams.[22] They argue that the through and out rates are unjust and unreasonable and should be immediately eliminated. Many argue that there is, in fact, sufficient evidence and precedential authority to warrant the elimination of these through and out rates.

23. Several parties contend that the Commission has already decided the issue of the justness and reasonableness of the RTORs in the July 31 Order.[23] These parties argue that the Commission would not have set the through and out rates for hearing in the first place if it did not believe the Presiding Judge held the authority to find them unjust and unreasonable and order their elimination.

24. Several parties also except to the Presiding Judge's finding that the choices of the New PJM Companies and Illinois Power do not create irrational seams.[24] They contend that the choices of these companies to join PJM did in fact create the inter-RTO seam problem being addressed in this proceeding. The excepting parties assert that, since the irrational nature of this seam increases the number of transactions that must pay pancaked rates, the RTORs are unjust and unreasonable. Edison Mission argues that the sheer inefficiencies and market distortions that result from the RTORs are reason alone to warrant their elimination.[25] The Michigan Commission notes that the resulting ''Swiss cheese'' configuration leads to some members of PJM being west of certain of the Midwest ISO members, with some of these Midwest ISO members being in the inequitable position of having to pay RTORs to access their own generation.[26]

25. Some parties argue that the Presiding Judge erred by failing to eliminate the RTORs for other reasons. For example, the excepting parties claim that the Presiding Judge erroneously failed to eliminate the RTORs even after agreeing that they promote inefficiency and acknowledging that the unusual seam configuration will exacerbate the adverse impacts of the through and out rates.[27] They contend that the Presiding Judge has an inherent responsibility to promote the public interest, yet neglected to do so by failing to eliminate the RTORs.

Briefs Opposing Exceptions

26. A number of parties agree with the Presiding Judge that there is no precedent for eliminating the RTORs at this time.[28] They state that many parties excepting to the Presiding Judge on the issue of precedent do not provide any citations to cases in which the Commission determined that it was unjust and unreasonable to charge for through and out service. The New PJM Companies and Classic PJM companies contend that the July 31 Order did not require the elimination of the RTORs; otherwise a hearing would not have been needed.[29] The New PJM Companies and PECO argue that the Commission's April 28, 2003 White Paper in Docket No. RM01–12–000[30] would allow PJM transmission owners to recover contributions to their transmission cost of service from Midwest ISO through access fees or export fees because of notable imbalances in the exports and imports between the expanded PJM and the expanded Midwest ISO.[31]

27. Several parties question the benefits of eliminating the RTORs. JCA contends that evidence in the record indicates that there may be no overall efficiency gains from eliminating the RTORs, which it argues may increase constraints between the two RTOs and allow customers to hoard transmission capacity.[32] JCA also argues, as do the Classic PJM Companies, that elimination of the RTORs would remove the distance component from rates, which could distort the market.[33] The Classic PJM Companies admit that the inefficiencies associated with the RTORs are likely to be significant once the common market is operational. They argue that the inefficiencies associated with the RTORs are likely to be much less during the period before the common market is operational, and they maintain that the RTORs should not be eliminated before such time.[34]

[21] Initial Decision at P 62–63.

[22] *See, e.g.*, Trial Staff, Edison Mission, Consumers, Michigan Agencies, Michigan Commission, Ohio Commission, Wisconsin Commission, MidAmerican, WEPCO, WPSC/UPPC, Madison, GridAmerica, TRRG, Cinergy, Illinois Power, Midwest ISO.

[23] *See* Ohio Commission Brief on Exceptions at 2, Michigan Agencies Brief on Exceptions at 10, MidAmerican Brief on Exceptions at 9, Midwest ISO Brief on Exceptions at 4.

[24] *See, e.g.*, Trial Staff, Michigan Agencies, Michigan Commission, WEPCO, Cinergy, Illinois Power, and Midwest ISO.

[25] *See* Edison Mission Brief on Exceptions at 10.

[26] *See* Michigan Commission Brief on Exceptions at 6.

[27] *See, e.g.*, MidAmerican Brief on Exceptions at 14, stating that ''the Initial Decision declines to eliminate seams charges for lack of perceived precedential authority, but it nonetheless identifies deficiencies with those seams charges as they now exist.''

[28] *See e.g.*, Classic PJM Companies, JCA, Maryland and Pennsylvania Commissions, New PJM Companies and PECO.

[29] *See* New PJM Companies Brief Opposing Exceptions at 11, Classic PJM Companies Brief Opposing Exceptions at 5.

[30] *See* Wholesale Market Platform White Paper (White Paper), Appendix A at 6.

[31] *See* New PJM Companies and PECO Brief Opposing Exceptions at 5 and Classic PJM Companies Brief Opposing Exceptions at 5–6.

[32] *See* JCA Reply Brief on Exceptions at 11 (citing testimony of Rodney Frame, Classic PJM Companies witness). Mr. Frame testified that elimination of the RTOR charges could result in hoarding of capacity across the inter-ties since there would be no payment for use ofthis capacity. *Id.*

[33] *Id.*

[34] *See* Classic PJM Companies Brief Opposing Exceptions at 26.

Commission Decision

28. We disagree with the Presiding Judge's conclusion that he did not have the authority to find the through and out rates for transactions crossing the proposed RTO boundary unjust and unreasonable. We would not have instituted an investigation, and established hearing procedures, pursuant to section 206 of the FPA, if the Presiding Judge lacked the authority to conclude that the rates were unjust and unreasonable. Moreover, the RTORs in the Midwest ISO/PJM region perpetuate seams that prevent the realization of more efficient and competitive electricity markets in the region, and thus violate a central tenet of the Commission's RTO policy.

29. Although the Presiding Judge correctly stated that Order No. 2000 does not require the elimination of rate pancaking between RTOs, Order No. 2000 also requires that RTOs meet certain minimum characteristics, including proper scope and configuration. Order No. 2000 also requires that RTOs eliminate rate pancaking within a region of appropriate scope and configuration.[35] Order No. 2000 emphasizes that this is a central goal of the Commission's RTO policy because rate pancaking restricts the amount of generation that can be economically delivered to any customer, thereby frustrating the realization of competitive and efficient bulk power markets.[36] In addition, Order No. 2000 indicates that, among the factors that will be considered when determining appropriate RTO configuration, the Commission will consider the extent to which the proposal would encompass one contiguous area, encompass a highly interconnected portion of the grid, and recognize trading patterns.[37] When we find that a proposed RTO does not meet the scope and configuration requirements of Order No. 2000, as we did with respect to the organizations resulting from certain former Alliance Companies' decisions to join PJM, the Commission must impose conditions on its acceptance of those decisions, such as requiring inter-RTO coordination agreements and/or the elimination of inter-RTO rate pancaking, in order to mitigate otherwise inappropriate RTO configuration.[38] While the Commission has not required the elimination of inter-RTO rate pancaking before, the Commission has not had to address the issue before; the circumstances presented in this proceeding are unprecedented.

30. The former Alliance Companies are uniquely situated in relation to two operating regional transmission organizations such that elimination of the seam between Midwest ISO and PJM is necessary to promote more efficient and competitive electricity markets and to meet the requirements of Order No. 2000. Some of the former Alliance Companies, including Illinois Power and the New PJM Companies, are located in the heart of the Midwest ISO region and have close links with their neighboring utilities in Midwest ISO. The Commission recognized the critical position of these companies vis-a-vis Midwest ISO when it granted the Midwest ISO RTO status. Specifically, the Commission originally noted that Midwest ISO had a configuration on its eastern border that was inconsistent with the scope and configuration requirements of Order No. 2000, and found that the problem would be solved by successful integration of some or all of the former Alliance Companies into Midwest ISO.[39]

31. Correspondingly, other former Alliance Companies are located along the western border of PJM. In the Commission's initial order on PJM's RTO proposal, the Commission found that PJM exhibited insufficient scope to meet the requirements of Order No. 2000 and encouraged PJM to continue its efforts to expand in the region.[40]

32. Thus, by virtue of their location and ties to their neighbors, the former Alliance Companies, through their failure to join RTOs, and also through their proposed RTO choices, create a barrier that obstructs more efficient and competitive electricity markets and the realization of adequate RTO scope and configuration in the region, thereby denying the benefits of more efficient and competitive regional electricity markets to customers in 21 states and one Canadian province.

33. As noted in the July 31 Order and the Rehearing Order, the choice of Illinois Power and the New PJM Companies to join PJM results in a long and irregular RTO border that perpetuates Midwest ISO's configuration problems. Specifically, as we discussed in the Rehearing Order, evidence indicates that the proposed RTO configuration would divide a highly interconnected portion of the grid, leaving in place an elongated and irregular seam across which significant trading activity takes place.[41] For example, 10,700 MVA transfer capability exists between Midwest ISO and the New PJM Companies and Illinois Power, while only 3,300 MVA of transfer capability exists between PJM and New PJM Companies and Illinois Power. Additionally, there is 66,500 MVA of tie line capacity between Midwest ISO and the New PJM Companies and Illinois Power, while only 6,000 MVA of tie line capacity exists between PJM and New PJM Companies and Illinois Power.[42] Notwithstanding their closer ties to Midwest ISO, the New PJM Companies and Illinois Power have opted to join PJM. Further, during a one-year period commencing June 1, 2001, AEP received 4,400 requests for transmission service into the Midwest ISO footprint for a total of 48,800 MW-years of transmission service, while AEP received only 1,500 requests for transmission service into PJM for a total of 12,500 MW-years of transmission service.[43] Again, notwithstanding the close ties to Midwest ISO, AEP has opted to join PJM. Thus, accepting the former Alliance Companies' RTO choices unconditionally would result in fewer benefits from one-stop shopping or the elimination of rate pancaking than if, for example, AEP joined Midwest ISO.[44] Other evidence indicates that, due to the entry of the New PJM Companies and Illinois Power into PJM, Michigan and Wisconsin would remain only partially contiguous with the rest of Midwest ISO, and companies in Michigan and Wisconsin would be required to pay pancaked rates in order to wheel power through PJM from elsewhere in Midwest ISO.[45] In addition, the record indicates that various other market participants will be adversely affected by continued rate

[35] *See* Order No. 200 at 31, 173.

[36] *Id.*

[37] *Id.* at 31,082–84.

[38] *See* Order No. 2000 at 31,083; *see also* Rehearing Order at P 31. As we explained in the July 31 Order, the alternative to accepting the former Alliance Companies' compliance filings with conditions was rejecting them. *See* July 31 Order at P 38.

[39] Midwest Independent Transmission System Operator, Inc., 97 FERC ¶ 61,326 (2001). As explained in the Rehearing Order, our granting of RTO status to Midwest ISO, despite this configuration problem, was entirely consistent with Order No. 2000's provision that RTO status would not be categorically denied or RTO start-up delayed where transmission owners representing a large majority of the facilities in a region are ready to move forward, even though agreement by a few transmission owners in the region has yet to be obtained. *See* Rehearing Order at P 43 n.36, Order No. 2000 at 31,086.

[40] On rehearing, the Commission found that PJM's planned expansion to incorporate some of the former Alliance Companies, as conditionally accepted in the July 31 Order, alleviated concerns regarding the possible insufficient scope of PJM as an RTO. PJM Interconnection, LLC *et al.*, 96 FERC ¶ 61,061 (2001), *order on reh'g,* 101 FERC ¶ 61,345 (2002).

[41] Rehearing Order at P 26–30.

[42] *Id.* at P 29, n.27.

[43] *Id.* at P 27.

[44] *Id.* at P 28.

[45] *Id.* at P 28 & n.26.

pancaking across the proposed seam, effects that would be eliminated had certain of the former Alliance Companies joined Midwest ISO instead of PJM.[46]

34. These facts thus indicate that the proposed RTO configuration would: (1) Preserve an elongated and irregular seam that divides a highly interconnected portion of the grid and a natural market; (2) leave portions of Midwest ISO barely contiguous with the rest of the region; and (3) subject a significant number of transactions in the region to continued rate pancaking. In addition, as we noted in the July 31 Order, decisions as to which RTO to join may be affected by inter-RTO rate pancaking. That is, transmission owners may be driven by the interests of their merchant function, rather than motivated by a desire to achieve the most rational and efficient RTO configuration, resulting in inappropriate RTO configuration that places the transmission owner's merchant function at a competitive advantage relative to other similarly situated market participants. Indeed, in this proceeding, one transmission owner stated that Midwest ISO's through and out rate was a factor in its decision to join PJM,[47] and both Midwest ISO and PJM agreed that this is an issue.[48]

35. In sum, the choices of the former Alliance Companies as to which RTOs they join: (1) Exacerbate rate pancaking across the proposed seam for transactions sinking within the RTOs, thereby obstructing more efficient and competitive electricity markets in the region; (2) violate the fundamental requirement of Order No. 2000 that RTOs eliminate rate pancaking over a region of appropriate scope and configuration; and (3) result in unjust, unreasonable, unduly discriminatory or preferential RTO rates.[49] Indeed, given Order No. 2000's requirement that RTOs eliminate rate pancaking over a region of appropriate scope and configuration, rate pancaking across the proposed seam is incorrectly characterized as *inter*-RTO rate pancaking; rather, it constitutes intra-RTO rate pancaking which is unequivocally prohibited under Order No. 2000. The solution is to eliminate the RTORs, *i.e.*, eliminate the through and out rates that constitute the rate pancaking, and in a very real sense constitute the seam.

36. We disagree with the New PJM Companies and PECO that eliminating the RTORs is inconsistent with the Commission's recently-issued White Paper. As an initial matter, we note that parties to this proceeding are in agreement that the RTORs must be eliminated when the common market becomes operational, in order to realize the goal of truly efficient and competitive electricity markets in the region. (As discussed above, it is due to the proposed RTO configuration that the Commission finds that Midwest ISO and PJM RTORs are unjust and unreasonable and directs Midwest ISO and PJM to eliminate these charges.) Furthermore, we note that, while the White Paper contemplates use of an export fee in situations where there is an imbalance between imports to and exports from a region, the White Paper reaffirms the RTO scope and configuration requirements of Order No. 2000.[50] Indeed, the replacement of RTORs with inter-regional allocation of transmission revenue requirements is consistent with the transmission pricing concepts advanced in the SMD NOPR and the White Paper.[51]

37. We also disagree with arguments that rate pancaking across the proposed seam provides beneficial price signals by incorporating an element of distance into transmission rates.[52] As we explain above, rate pancaking across the proposed seam obstructs more efficient and competitive electricity markets and thus violates Order No. 2000's goal and requirement that RTOs eliminate rate pancaking within regions of appropriate scope and configuration. Moreover, in Order No. 2000, the Commission rejected similar arguments that the Commission allow rate pancaking within RTOs in order to reflect distance in rates. In doing so, the Commission essentially rejected rate pancaking based on corporate boundaries as a supportable distance-based rate methodology.[53] Rate pancaking across the proposed seam suffers from the same flaw.[54] Because the RTORs are based on embedded transmission costs, they can have a distorting effect on economic choices.[55] Thus, we disagree that the RTORs provide beneficial price signals. In this regard, we affirm the Presiding Judge's finding that the configuration of the seam argues against relying on rate pancaking across the seam to incorporate an element of distance in rates.[56]

38. With respect to the concerns expressed by JCA and the Classic PJM Companies that eliminating the RTORs may result in hoarding of capacity, we agree with Cinergy that there are other, better means to discourage hoarding of transmission capacity than to perpetuate unjust and unreasonable rates. We will direct the market monitors of PJM and Midwest ISO to assess the potential for, and to look for signs of, hoarding of transmission capacity. Should they detect any, they should notify us and their respective RTOs immediately, and the RTOs should promptly file a proposal to rectify the matter.

39. Accordingly, the Commission finds that the PJM and Midwest ISO RTORs, when applied to transactions sinking within the proposed Midwest ISO/PJM footprint, are unjust and unreasonable and must be eliminated. As discussed below, we will eliminate them effective November 1, 2003,[57] in order to provide sufficient time for the parties to prepare the appropriate filings and the Commission to review those filings.[58]

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[46] *See, e.g.*, Exhibit No. CAS–1 at 13–18.

[47] June 26, 2002 Commission Meeting, Tr. at 321.

[48] July 17, 2002 Commission Meeting, Tr. at 176–77.

[49] We note that only four parties in this proceeding object to the elimination of the through and out rates (New PJM Companies and PECO, JCA, Classic PJM Companies, and the Maryland and Pennsylvania Commissions). However, even certain of these parties recognize inefficiencies related to the through and out rates and benefits of eliminating them. *See* Tr. at 185 (where a witness for the New PJM Companies recognizes that elimination of rate pancaking would represent an improvement); Exhibit No. Certain Classic PJM TOs–1 at 24 (recognizing that through and out rates are inefficient and should be eliminated when a common market is implemented).

[50] *See* White Paper, Appendix A at 3.

[51] *Id.* at 6; SMD NOPR at P 183–89.

[52] JCA Brief on Exceptions at 13.

[53] *See* Order No. 2000 at 31,174–75. However, the Commission clarified that it would be receptive to distance-sensitive rates that can be justified.

[54] Indeed, the record indicates that, due to the irregular contour of the proposed seam, rate pancaking across it does not accurately incorporate distance into rates. *See* Tr. at 212–14 (indicating that a hypothetical transaction sourcing in Richmond, Virginia and sinking in Chicago, Illinois would not be subject to pancaked rates, while a transaction sourcing in Gary, Indiana and sinking in Chicago would be subject to pancaked rates).

[55] *See* Exhibit No. CAS–1 at 9.

[56] Initial Decision at P 63.

[57] We disagree with the Classic PJM Companies that the Commission should not eliminate the RTORs before the common market is operational. As discussed above, the RTORs violate Order No. 2000 and are unjust and unreasonable. This is true regardless of whether the common market has become operational. While we expect the most benefits in terms of more efficient and competitive markets once the common market is operational, the elimination of the RTORs during the transition to a common market will accelerate the realization of those benefits.

[58] Further, we note that ComEd plans to be fully integrated into PJM on November 1, 2003. *See* Press Release, PJM Interconnection, Market Implementation Date for Northern Illinois Region Confirmed for November 1 (July 11, 2003), available at *http://www.pjm.com/contributions/news-releases.* On July 11, 2003, in a status report filed in Docket No. ER02–22–002, *et al.*, GridAmerica indicated that it is on schedule to become operational under the Midwest ISO as of October 1, 2003.

If GridAmerica and ComEd meet these targets, the individual-company tariffs of the individual GridAmerica Participants and ComEd will be superseded by the applicable RTO tariff, and rate

40. While we named the through and out rates under the Midwest ISO and PJM OATTs as the rates subject to investigation in Docket No. EL02–111–000, we expected that the inter-RTO seam would be the only seam remaining at the close of Docket No. EL02–111–000. When we conditionally accepted the former Alliance Companies' RTO choices a year ago, we relied upon their express intentions and commitments so that, by acting expeditiously in allowing each company to proceed to join the RTO of its choosing, those choices would be implemented, and the resulting benefits would be realized—quickly. The timely elimination of rate pancaking in this region of the country, which, as we discuss above, is critical to achieving competitive and efficient electric markets, was fundamental to our decision to accept the former Alliance Companies RTO choices.

41. Even with elimination of the Midwest ISO and PJM RTORs, in the near term the region will still be riddled with seams, with the through and out rates under the individual-company tariffs of AEP, Ameren Services Companies on behalf of certain public utility affiliates [59] (collectively, Ameren), ComEd, First Energy Corp. on behalf of certain public utility affiliates (collectively, First Energy),[60] Illinois Power, Northern Indiana Public Service Company (NIPSCO), and DP&L acting as toll gates that impede the realization of more efficient and competitive electricity markets in the region and that preserve a competitive advantage for the non-RTO participants' merchant functions. We find that the through and out rates under the tariffs of these individual former Alliance Companies,[61] for transactions sinking in the proposed Midwest ISO/PJM footprint, may be unjust, unreasonable, and unduly discriminatory or preferential, and, pursuant to section 206 of the FPA, we will initiate an investigation and hearing in Docket No. EL03–212–000. We will provide for a ''paper'' hearing [62] to determine whether the through and out rates contained in the tariffs of AEP, Ameren, ComEd, First Energy, Illinois Power, NIPSCO, and DP&L are just, reasonable, and not unduly discriminatory or preferential. Given our statutory responsibility to ensure these rates are just and reasonable, we believe that expeditious resolution of this proceeding is critical. Accordingly, the Commission will provide AEP, Ameren, ComEd, First Energy, Illinois Power, NIPSCO and DP&L, and interested parties, with an opportunity to file, explaining why the rates are or are not unjust, unreasonable or unduly discriminatory or preferential, on or before August 15, 2003.

42. Where, as here, the Commission initiates a section 206 investigation on its own motion, section 206(b) requires that the Commission establish a refund effective date anywhere from 60 days after publication in the **Federal Register** of notice of its initiation of a proceeding to five months after the expiration of the 60-day period. In order to give maximum protection to customers, and consistent with our precedent, we will establish the refund date at the earliest date allowed. This date will be 60 days from the date on which notice of the initiation of the investigation in Docket No. EL03–212–000 is published in the **Federal Register**.

43. Section 206(b) also requires that if no final decision is rendered in the Commission's investigation by the refund effective date or by the conclusion of the 180-day period commencing upon the initiation of a proceeding pursuant to section 206, whichever is earliest, the Commission shall state the reasons why it has failed to do so and shall state its best estimate as to when it reasonably expects to make such a decision. The Commission expects to issue its final decision in Docket No. EL03–212–000 by October 31, 2003.

SECA Issue

Presiding Judge's Ruling

44. The Presiding Judge stated that if the Commission were to order the elimination of the RTORs, he would recommend that the Commission adopt, without requiring the filing of new rate cases, a mechanism such as one of the SECAs proposed by the parties to prevent cost shifting between customers of the two RTOs.[63] The various SECAs proposed by the parties are generally designed as non-by-passable surcharges to license plate zonal rates for delivery to load within the RTOs.[64] The Presiding Judge found that eliminating the RTORs without a SECA would improperly shift costs from Midwest ISO's native load to PJM's native load.[65] The Presiding Judge took the position that inappropriate cost shifting will occur if RTORs are eliminated absent a lost revenue recovery mechanism because ''the through and out revenues are no longer credited against the cost of service and native load customers assume the burden previously carried by importing customers in the form of an increase in their own rates.'' [66]

Briefs on Exceptions

45. Many parties objecting to a lost revenue recovery mechanism challenge the Initial Decision's position that transmission owners are entitled to a specific amount of revenue related to through and out transactions.[67] The Michigan Agencies assert that the concept of ''lost revenues'' is also faulty since transmission owners are not legally guaranteed any particular stream of revenues. They note that the FPA only allows them to recover costs plus a reasonable return. WEPCO states that, if there is any question as to whether a transmission owner is over-recovering its revenue requirement, then the Commission should review the transmission owners' actual cost of service. WEPCO continues that a SECA-type mechanism would be appropriate for use (for a short period of time) only if the transmission owner can establish that it will be unable to recover its current cost of service without

pancaking over their transmission systems for transactions sinking within the proposed Midwest ISO/PJM footprint will be eliminated.

[59] Union Electric Co. and Central Illinois Public Service Co.

[60] American Transmission Systems, Inc., Cleveland Electric Illuminating Power Co., Ohio Edison Co., Pennsylvania Power Co., Toledo Edison Co.

[61] AEP, Ameren, ComEd, First Energy, Illinois Power, NIPSCO, and DP&L. *See supra* note 58.

[62] The use of a ''paper'' hearing, rather than a trial-type, evidentiary hearing, has been addressed in previous cases. *See, e.g.,* Public Service Company of Indiana, 49 FERC ¶ 61,346 (1989), *order on reh'g,* 50 FERC ¶ 61,186, *opinion issued,* Opinion 349, 51 FERC ¶ 61,367, *order on reh'g,* Opinion 349–A, 52 FERC ¶ 61,260, *clarified,* 53 FERC ¶ 61,131 (1990), *appeal dismissed, Northern Indiana Public Service Company* v. *FERC,* 954 F.2d 736 (DC Cir. 1992). As the Commission noted in Opinion No. 349, 51 FERC at 62,218–19 & n.67, while the FPA and the case law require that the Commission provide the parties with a meaningful opportunity for a hearing, the Commission is required to reach decisions on the basis of an oral, trial-type evidentiary record only if the material facts in dispute cannot be resolved on the basis of the written record, *i.e.,* where the written submissions do not provide an adequate basis for resolving disputes about material facts.

[63] Initial Decision at P 7.

[64] The proposed SECAs reflect the historical test-year transmission charges that customers in a given pricing zone in one RTO paid for transmission service over the facilities in the other RTO to serve load within the pricing zone, and are designed to collect revenue from each zone in proportion to the benefits that customers serving load within the zone will realize when they no longer pay pancaked rates for transmission service over the facilities in the other RTO.

Transactions under Grandfathered Agreements and transactions that sink outside the combined region are not included in these calculations.

NERC tag data would be used to identify the loads benefitting from particular through and out transactions, and lost through and out service revenues would be assigned to loads on the basis of such analysis.

[65] Initial Decision at P 82.

[66] Initial Decision at P 71.

[67] *See, e.g.,*. Michigan Agencies, Michigan Commission, TRRG, WSPC and UPPC, Maryland and Pennsylvania Commissions.

increasing its zonal rates once the RTORs are eliminated.[68] TRRG similarly argues that before the Commission approves any lost revenue recovery, it must determine that each transmission owner requesting lost revenue recovery would otherwise be deprived of its ability to recover its costs and earn a reasonable return on its investment.[69] The Wisconsin Commission argues that the burden should be on the New PJM Companies to demonstrate that they would not over-recover their current cost of service with implementation of a transitional rate mechanism.[70]

46. TRRG states that a cost-based approach to mitigating cost-shifts and eliminating rate pancaking, namely license plate rates with no lost revenue adders, has been used by the Commission in approving rates for the New York Independent System Operator, Inc., ISO-New England and PJM. It suggests that, given the intertwined nature of PJM and Midwest ISO, the Commission should view elimination of the RTORs as involving the elimination of intra-regional rate pancaking, and follow those cases.[71]

47. The Michigan Commission claims that there are legitimate reasons for denying any recovery of lost revenues in this proceeding in light of the former Alliance Companies' RTO choices. The Michigan Commission notes that the former Alliance Companies have continued to charge through and out rates far beyond the seams elimination date prescribed in the Illinois Power Settlement.[72] They argue that this continued recovery of revenues under pancaked rates serves as enough of a transition period and mitigates the need for any further recovery of lost revenues.[73]

Briefs Opposing Exceptions

48. Several parties support the Presiding Judge's ruling that a lost revenue recovery mechanism is necessary in the event that the Commission decides to eliminate the pancaked rates.[74] GridAmerica Companies and the New PJM Companies agree that transmission owners should be entitled to collect any revenues lost from the elimination of rate pancaking, and further argue that a full cost of service analysis should not be a necessary prerequisite for such recovery. They argue that requiring such filings would be inconsistent with established Commission precedent.[75] Trial Staff also notes that the Commission has previously adopted proposals to collect lost revenues in an effort to remove disincentives to RTO membership without requiring a new, full cost of service.[76] The New PJM Companies argue that if the Commission eliminates the RTORs, then it is obligated under Section 206 of the FPA to establish a just and reasonable alternative.[77]

Commission Decision

49. In prior cases, the Commission has approved the elimination of rate pancaking with a transitional rate mechanism for the recovery of lost revenues when the parties experiencing such lost revenues requested a transitional rate mechanism and demonstrated that it was just and reasonable.[78] On the other hand, the Commission has also approved the elimination of rate pancaking without such transitional rate mechanisms for recovery of lost revenues in cases where parties did not propose them or adequately support them.[79] That is, the Commission is not bound to establish transitional rate mechanisms for recovery of lost revenues.

50. We believe that mechanisms such as the proposed SECAs, if properly structured, can serve as reasonable transition mechanisms to address revenue losses arising from the elimination of rate pancaking due to RTO formation. However, no party to the proceeding has yet made a rate filing under section 205 of the FPA, 16 U.S.C. 824d (2000), either to increase its rates or to adopt a transitional rate mechanism to recover lost revenues.[80] If parties desire to increase their rates or to utilize such a transitional rate mechanism to recover lost revenues, they should file pursuant to section 205 of the FPA. For those filings made prior to November 1, 2003, we will look favorably upon requests to waive the prior notice requirement to allow an effective date of November 1, 2003, the date that the through and out rates will be eliminated.

51. Some parties state that the proper benchmark to use to set rates is the cost of providing service, including expenses and a fair return on investment, not revenue levels under current rates. Consistent with prior rulings,[81] however, we will not require that RTO members file an updated complete cost-of-service in order to justify transitional surcharges to recover lost revenues arising from the elimination of rate pancaking due to RTO formation.[82] Such a requirement could create an unnecessary impediment to RTO formation. However, if customers feel that existing rates and revenues, upon which the transitional surcharges would be based, are no longer just and reasonable, they may file a complaint pursuant to section 206 of the FPA to seek a change in those rates and the corresponding transitional surcharges.[83]

Specific Attributes of the SECA

52. Two SECA proposals were sponsored by parties to the proceeding, one by GridAmerica and one by the Midwest ISO TOs. The Presiding Judge made certain recommendations regarding the specific attributes of the SECA. Specifically, the Presiding Judge recommended that: (1) Calender-year 2002 should be the test period; (2) there should be no phase-out of the SECA until another methodology is devised to ensure that there is no cost shifting to PJM's native load customers; (3) Michigan and Wisconsin customers should be able to opt out of the SECA and continue paying the RTORs; (4) the starting point for the elimination of the RTORs and implementation of any

[68] WEPCO Brief on Exceptions at 27–30.

[69] TRRG Brief on Exceptions at 24.

[70] Wisconsin Commission Brief on Exceptions at 7.

[71] See TRRG Brief on Exceptions at 46.

[72] *See* Illinois Power Company, *et al.,* 95 FERC ¶ 61,183, *order denying reh'g,* 96 FERC ¶ 61,026 (2001).

[73] *See* Michigan Commission Brief on Exceptions at 16. WEPCO makes a similar argument in its Brief on Exceptions at 25.

[74] New PJM Companies and PECO, GridAmerica Companies, Ormet, Trial Staff, Illinois Power, the Midwest ISO TOs.

[75] *See also,* GridAmerica Companies Brief Opposing Exceptions at 19, New PJM Companies and PECO Brief Opposing Exceptions at 34.

[76] *See* Trial Staff Brief Opposing Exceptions at 11.

[77] New PJM Companies and PECO Brief Opposing Exceptions at 34.

[78] *See* Alliance Cos., *et al.,* 94 FERC ¶ 61,070 (2001); *see also* PJM Interconnection, LLC and Allegheny Power Co., *et al.,* 96 FERC ¶ 61,060 (2001).

[79] *See* PJM Interconnection, LLC, 81 FERC ¶ 61,257 (1997); *see also* Midwest Independent Transmission System Operator, Inc., *et al.*, Opinion No. 453, 97 FERC ¶ 61,033 (2001), *order on reh'g,* Opinion No. 453–A, 98 FERC ¶ 61,141 (2002).

[80] Likewise, no party to this proceeding has developed a record sufficient for us to order increased rates or to adopt a particular transitional rate mechanism for any party in this proceeding.

[81] *See* Alliance Companies, *et al.,* 94 FERC ¶ 61,070, *reh'g denied*, 95 FERC ¶ 61,182 (2001); April 25 Order at 61,446; PJM Interconnection L.L.C and Allegheny Power, 96 FERC ¶ 61,060 (2001).

[82] We do not address here whether this same approach, *i.e.,* not requiring an updated complete cost-of-service (as opposed to requiring such a cost-of-service with a demonstration that a party would otherwise be deprived of the ability to recover its cost-of-service due to the elimination of rate pancaking), would be appropriate for a public utility that has not yet joined an RTO.

[83] While parties to this proceeding presented evidence that they claimed demonstrated that the level of certain transmission owners' existing license plate rates was excessive, as the Presiding Judge correctly found, this analysis was hardly free from doubt and did not convincingly show that the existing rates were unjust and unreasonable. Initial Decision at P 74.

SECA should be after a final Commission order, allowing enough time for the filing of compliance filings containing the requisite calculations, and no refunds should be ordered; (5) the SECA should replace only charges for through and out service for transactions that sink in either the expanded Midwest ISO or the expanded PJM and source in or wheel through the other RTO; and (6) the Commission must decide as a matter of policy whether the SECA should be charged to the sink RTO as a whole or whether there should be a sub-zonal option.[84]

53. Most parties supported at least some of the Presiding Judge's recommendations while opposing the other recommendations.

Commission Decision

54. We cannot rule here on the Presiding Judge's recommendations or the parties' various concerns with the mechanics of the SECA. We will examine the specific attributes of any transitional cost recovery mechanisms when parties make section 205 filings, as discussed above.[85] However, based on our experience, we will provide the following guidance in this regard. As a general matter, we believe that any such filing should use NERC tag data and develop lost through and out revenues for the most recent twelve months, with adjustments for known and measurable differences, to most closely reflect future trading patterns. In addition, the transitional period for a SECA should be as short as possible, while allowing enough time for parties to develop a permanent solution to pricing transmission service between the regions. We believe that a two-year transition period for a transition cost recovery mechanism will provide sufficient time for the parties to find a permanent solution for pricing transmission service between regions in the Midwest ISO/PJM footprint. We will also permit charges on a sub-zonal basis, since sub-zonal charges best align the benefits of eliminating rate pancaking with the associated lost revenues. If transactions cannot be traced to load in various zones of the Classic PJM Companies' region, because of operation of the PJM spot market, Classic PJM Companies should address alternative methodologies for evaluating the relative benefits from import transactions between the various zones of the Classic PJM Companies' region.[86] Finally, we encourage those entities that intend to make Section 205 filings to consult with interested parties and each other, to seek creative solutions to the concerns raised in this proceeding and to resolve as many issues as possible prior to making their Section 205 filings.

55. The Presiding Judge explained that efficiencies could only be produced by eliminating rate pancaking after the Commission issues a final order since past behavior cannot be changed.[87] Therefore, he recommended that no refunds should be ordered for past through and out charges. The Presiding Judge also ruled that no refunds should be ordered because the SECA replaces the RTORs with charges of a different form, a non-by-passable surcharge to be added to existing license plate zonal transmission rates but in approximately the same magnitude and imposed on the same groups of ratepayers; customers are not entitled to refunds because they have not overpaid.[88]

56. Consumers argues that, because the Commission set a refund effective date, refunds should be available if the RTORs are found to be unjust and unreasonable. Midwest ISO TOs argue that, if the Commission requires elimination of the through-and-out rates, the elimination should be on a prospective basis, without refunds, and take effect simultaneous with the implementation of the SECA charge.

57. We affirm the Presiding Judge and will not order refunds here. Rather, as discussed above, we will make the elimination of the through and out rates effective on November 1, 2003. We direct PJM and Midwest ISO to make a compliance filing, within 30 days, eliminating the RTORs under their tariffs for transactions that sink in the Midwest ISO/PJM footprint into proposed RTOs, effective November 1, 2003.

The Commission orders:

(A) The Initial Decision is hereby affirmed in part, and reversed in part, as discussed in the body of this order. The through and out rates under the tariffs of Midwest ISO and PJM for transactions sinking within their combined region, are hereby eliminated effective November 1, 2003, as discussed in the body of this order.

(B) The Wisconsin Commission's motion to intervene is hereby denied, but the Wisconsin Commission is hereby granted permission to participate as amicus curiae, as discussed in the body of this order.

(C) Pursuant to the authority contained in and subject to the jurisdiction conferred upon the Federal Energy Regulatory Commission by section 402(a) of the Department of Energy Organization Act and by the Federal Power Act, particularly Section Procedure and the 206 thereof, and pursuant to the Commission's Rules of Practice and regulations under the Federal Power Act (18 CFR chapter I), a public hearing shall be held in Docket No. EL03–212–000 concerning the justness and reasonableness of the through and out rates of AEP, Ameren, ComEd, First Energy, Illinois Power, NIPSCO, and DP&L, as discussed in the body of this order.

(D) AEP, Ameren, ComEd, First Energy, Illinois Power, NIPSCO and DP&L and other parties may submit to the Commission in Docket No. EL03–212–000 arguments and evidence, as outlined in the body of this order on or before August 15, 2003.

(E) Any interested person desiring to be heard in Docket No. EL03–212–000 should file a notice of intervention to intervene with the Federal Energy Regulatory Commission, 888 First Street, NE., Washington, DC 20426, in accordance with Rule 214 of the Commission's Rules of Practice and Procedure (18 CFR 385.214) on or before August 8, 2003.

(F) The Secretary shall promptly publish in the **Federal Register** a notice of the Commission's initiation of the proceeding in Docket No. EL03–212–000.

(G) The refund effective date established pursuant to section 206(b) of the FPA will be 60 days following publication in the **Federal Register** of the notice discussed in Ordering Paragraph (F) above.

(H) The Secretary shall promptly publish this order in the **Federal Register**.

By the Commission.

Magalie R. Salas,

Secretary.

[84] Initial Decision at P 91–97.

[85] We note that, in the April 25 Order, while we found that a transitional rate mechanism appeared promising in concept, we stated that we would still need to evaluate the resulting rates to ensure that the mechanism produces a reasonable result. Consistent with the April 25 Order, we do not have actual rates before us here, and therefore, will not render a decision on any particular methodology.

[86] We remind the parties that such a methodology will likely be necessary, in any event, for a long-term solution to pricing transmission service between regions.

[87] Initial Decision at P 95.

[88] The Presiding Judge states that the parties which contested the RTOR are not contesting the level of the RTORs. Initial Decision at P 56.

APPENDIX

	Acronym
Cinergy Services, Inc., Cincinnati Gas and Electric Co., PSI Energy Inc., Union Light and Heat Co.	Cinergy.
Certain Classic PJM Transmission Owners	Classic PJM Companies.
Consumers Energy Company	Consumers.
Dairyland Power Cooperative	Dairyland Power.
Edison Mission Energy	Edison Mission.
Grid America Companies	GridAmerica.
Illinois Power Company	Illinois Power.
Joint Consumer Advocates	JCA.
Madison Gas and Electric Company	Madison.
Maryland Public Service Commission and Pennsylvania Public Utility Commission	Maryland and Pennsylvania Commissions.
Michigan Public Power Agency and Michigan South Central Power Agency	Michigan Agencies.
Michigan Public Service Commission and the State of Michigan	Michigan Commission.
MidAmerican Energy Company	MidAmerican.
Midwest Independent System Operator	the Midwest ISO.
Midwest ISO Transmission Owners	Midwest ISO TOs.
New PJM Companies and PECO Energy Company	New PJM Companies and PECO.
Public Utilities Commission of Ohio	Ohio Commission.
Ormet Primary Aluminum Corporation	Ormet.
Commission Trial Staff	Trial Staff.
Transmission Revenue Requirement Group	TRRG.
Wisconsin Electric Power Company	WEPCO.
Public Utilities Commission of Wisconsin	Wisconsin Commission.
Wisconsin Public Service Corporation and Upper Peninsula Power Company	WPSC/UPPC.

[FR Doc. 03–19796 Filed 8–1–03; 8:45 am]

BILLING CODE 6717–01–P

DEPARTMENT OF ENERGY

Federal Energy Regulatory Commission

[Docket No. AC03–58–000, et al.]

AEP Texas North Company, et al.; Electric Rate and Corporate Filings

July 25, 2003.

The following filings have been made with the Commission. The filings are listed in ascending order within each docket classification.

1. AEP Texas North Company, Appalachian Power Company, Columbus Southern Power Company, Ohio Power Company, Southwestern Electric Power Company

[Docket No. AC03–58–000]

Take notice that on July 17, 2003, the AEP Texas North Company, Appalachian Power Company, Columbus Southern Power Company, Ohio Power Company and Southwestern Electric Power Company (the Companies) made a compliance filing pursuant to the accounting and reporting requirements set forth by the Commission in Order 631, Accounting, Financial Reporting, and Rate Filing Requirements for Asset Retirement Obligations. The Commission directed jurisdictional entities to file journal entries and supporting information for any adjustments made that affect net income as a result of implementing the accounting rules contained in Order 631.

Comment Date: August 7, 2003.

2. Armstrong Energy Limited Partnership, LLLP and Dominion Energy Marketing, Inc.

[Docket No. EC03–108–000]

Take notice that on July 18, 2003, Armstrong Energy Limited Partnership, LLLP (Armstrong) and Dominion Energy Marketing, Inc. (DEMI) filed an application for an order authorizing the proposed transfer of Armstrong's interest in a Master Power Purchase & Sale Agreement and the underlying Confirmation Letter with Constellation Power Source, Inc. to its affiliate, DEMI.

Comment Date: August 8, 2003.

3. Dominion Nuclear Marketing II, Inc. and Dominion Energy Marketing, Inc.

[Docket No. EC03–109–000]

Take notice that on July 18, 2003, Dominion Nuclear Marketing II, Inc. (DNM II) and Dominion Energy Marketing, Inc. (DEMI) filed an application for an order authorizing the proposed transfer of DNM II's interest in certain wholesale contracts with Constellation Power Source, Inc. to its affiliate, DEMI.

Comment Date: August 8, 2003.

4. Texas-New Mexico Power Company and Southern New Mexico Electric Company

[Docket No. EC03–110–000]

Take notice that on July 21, 2003,Texas-New Mexico Power Company and Southern New Mexico Electric Company (Applicants) filed with the Federal Energy Regulatory Commission (Commission) an application pursuant to section 203 of the Federal Power Act for authorization of a disposition of jurisdictional facilities whereby Texas-New Mexico Power Company proposes to completely dispose of its jurisdictional facilities in New Mexico to Southern New Mexico Electric Company, a wholly owned subsidiary of Texas-New Mexico Power Company.

Comment Date: August 11, 2003.

5. Liberty Electric Power, LLC, Newco, LLC

[Docket Nos. EC03–111–000 and ER01–2398–005]

Take notice that on July 21, 2003, Newco, LLC (Applicant) filed with the Federal Energy Regulatory Commission (Commission) an application pursuant to Section 203 of the Federal Power Act and notice of change in status with respect to the transfer of 100 percent of the indirect upstream membership interests in Liberty Electric Power, LLC (Project Company) to Applicant, a newly created special purpose entity owned by a group of financial institutions. The Project Company owns a 567.7 MW combined cycle gas-fueled electric generating plant located in the Borough of Eddystone, Delaware County, Pennsylvania.

Comment Date: August 11, 2003.

6. Xcel Energy Inc. and NRG Energy, Inc., and its Public Utility Subsidiaries

[Docket No. EC03–112–000]

Take notice that on July 22, 2003, Xcel Energy Inc. (Xcel Energy) and NRG Energy, Inc. (on its behalf and behalf of its jurisdictional subsidiaries) (NRG) (collectively, Applicants) filed with the Federal Energy Regulatory Commission (Commission), an application pursuant to sections 203 and 204 of the Federal Power Act for authorization of a disposition of jurisdictional facilities whereby Xcel Energy would dispose of its entire equity interest in NRG by implementing a proposed plan of reorganization (Reorganization Plan) filed in the bankruptcy proceedings in the United States Bankruptcy Court for the Southern District of New York (Bankruptcy Court). Under the proposed Reorganization Plan, NRG's Creditors would acquire the equity interest in NRG, and Xcel Energy would make payments to NRG and its Creditors of up to $752 million. Upon implementation of the Reorganization Plan, Xcel Energy's common equity interests in NRG and its public utility subsidiaries would be cancelled.

Comment Date: August 25, 2003.

7. Central Vermont Public Service Corporation and Green Mountain Power Corporation

[Docket No. EC03–113–000]

Take notice that on July 22, 2003, Central Vermont Public Service Corporation (Central Vermont) and Green Mountain Power Corporation (Green Mountain) filed with the Federal Energy Regulatory Commission (Commission), an application pursuant to Section 203 of the Federal Power Act for authorization to purchase certain shares of non-voting Class C Common Stock ($100 par value) issued by the Vermont Electric Power Company, Inc. (VELCO). The Vermont Public Service Board states that it has previously approved the issuance of the stock by VELCO. Central Vermont and Green Mountain request expedited approval to permit the rationalization of ownership of VELCO consistent with usage of the system and to allow VELCO to obtain needed capital for its operations.

Central Vermont and Green Mountain state that copies of the filing were served upon the Vermont Public Service Board and the Vermont Department of Public Service.

Comment Date: August 12, 2003.

8. Otter Tail Power Company

[Docket No. ER03–1097–000]

Take notice that on July 21, 2003, Otter Tail Power Company (Otter Tail) filed a Collector System and Substation Works Agreement by and between FPL Energy North Dakota Wind, LLC and Otter Tail (Agreement). Otter Tail requests an effective date of April 1, 2003 for the Agreement.

Comment Date: August 11, 2003.

9. Delmarva Power & Light Company

[Docket No. ER03–1098–000]

Take notice that on July 21, 2003, Delmarva Power & Light Company (Delmarva) tendered for filing revised rate schedule sheets (Revised Sheets) in its Second Revised Rate Schedule FERC No. 111 between Delmarva and the Town of Middletown, Delaware (Middletown). Delmarva states that the Revised Sheets reflect a new effective date commensurate with the commercial operations date of Middletown's recently constructed substation and associated facilities.

Delmarva requests that the Commission allow the Revised Sheets to become effective on June 24, 2003, the commercial operations date of Middletown's substation and associated facilities.

Delmarva states that copies of the filing were served upon Middletown and the Delaware Public Service Commission.

Comment Date: August 11, 2003.

Standard Paragraph

Any person desiring to intervene or to protest this filing should file with the Federal Energy Regulatory Commission, 888 First Street, NE., Washington, DC 20426, in accordance with Rules 211 and 214 of the Commission's Rules of Practice and Procedure (18 CFR 385.211 and 385.214). Protests will be considered by the Commission in determining the appropriate action to be taken, but will not serve to make protestants parties to the proceeding. Any person wishing to become a party must file a motion to intervene. All such motions or protests should be filed on or before the comment date, and, to the extent applicable, must be served on the applicant and on any other person designated on the official service list. This filing is available for review at the Commission or may be viewed on the Commission's Web site at *http://www.ferc.gov*, using the ''FERRIS'' link. Enter the docket number excluding the last three digits in the docket number field to access the document. For assistance, please contact FERC Online Support at *FERCOnlineSupport@ferc.gov* or toll-free at (866) 208–3676, or for TTY, contact (202) 502–8659. Protests and interventions may be filed electronically via the Internet in lieu of paper; *see* 18 CFR 385.2001(a)(1)(iii) and the instructions on the Commission's Web site under the ''e-Filing'' link. The Commission strongly encourages electronic filings.

Magalie R. Salas,

Secretary.

[FR Doc. 03–19679 Filed 8–1–03; 8:45 am]

BILLING CODE 6717–01–P

DEPARTMENT OF ENERGY

Federal Energy Regulatory Commission

[Docket No. EL03–207–001, et al.]

PJM Interconnection, L.L.C., et al.; Electric Rate and Corporate Filings

July 24, 2003.

The following filings have been made with the Commission. The filings are listed in ascending order within each docket classification.

1. PJM Interconnection, L.L.C.

[Docket No. EL03–207–001]

Take notice that on July 22, 2003, PJM Interconnection, LLC (PJM) tendered for filing with the Federal Energy Regulatory Commission (Commission) revised tariff sheets in compliance with the Commission's July 14, 2003 ''Order on Complaint'' issued in Outback Power Marketing, Inc. *v.* PJM Interconnection, L.L.C., 104 FERC ¶ 61,079 (2003), to incorporate its credit policy in its Tariff.

PJM states that the tariff sheets bear a July 14, 2003 effective date, consistent with the Commission's Order.

PJM states that copies of this filing have been served on all PJM members and utility regulatory commissions in the PJM region and on all parties listed on the official service list compiled by the Secretary in this proceeding.

Comment Date: August 12, 2003.

2. New York Independent System Operator, Inc.

[Docket No. ER03–766–001]

Take notice that on July 21, 2003, the New York Independent System Operator, Inc. (NYISO) filed compliance revisions to its Open Access Transmission Tariff and its Market Administration and Control Area Services Tariff pertaining to the mechanism by which the NYISO pricing rules will reflect actions taken by the NYISO to minimize or prevent an actual shortage condition to meet load and reserves.

The NYISO states it has served a copy of this filing to all persons on the official service list for Docket No. ER03–766–000. The NYISO states it has also served copies of this filing upon all parties that have executed service agreements under the NYISO's Open Access Transmission Tariff or the Market Administration and Control Area Services Tariff and upon the New York State Public Service Commission.

Comment Date: August 11, 2003.

3. Illumina Energy Solutions, Inc.

[Docket No. ER03–876–000]

Take notice that on July 22, 2003, Illumina Energy Solutions, Inc. (Illumina Energy) submitted an amendment to its petition originally filed on May 27, 2003 for acceptance of Illumina Energy Solutions, Inc. FERC Electric Tariff Original Volume No. 1; the granting of certain blanket approvals, including the authority to sell electricity at market-based rates; and the waiver of certain Commission regulations.

Illumina Energy states that it intends to engage in wholesale electric power and energy purchases and sales as a marketer. Illumina Energy also states that it is not in the business of generating or transmitting electric power.

Comment Date: August 12, 2003.

4. Puget Sound Energy, Inc.

[Docket No. ER03–919–001]

Take notice that on July 21, 2003, Puget Sound Energy, Inc. (Puget) tendered for filing an amendment to its filing of June 4, 2003 submitting Amendment No. 3 to the Exchange and Transfer Agreement between Puget and the City of Seattle, acting by and through its City Light Department (the City) Puget states that a copy of the filing was served upon the City.

Comment Date: August 11, 2003.

5. Puget Sound Energy, Inc.

[Docket No. ER03–921–001]

Take notice that on July 21, 2003, Puget Sound Energy, Inc. (Puget) tendered for filing an amendment to its filing of June 4, 2003 submitting an unsigned Interconnection Agreement Amendment between Puget and the City of Seattle, acting by and through its City Light Department (the City).

Puget states that a copy of the filing was served upon the City.

Comment Date: August 11, 2003.

6. New England Power Pool

[Docket No. ER03–1089–001]

Take notice that on July 21, 2003, the New England Power Pool (NEPOOL) amended its July 18, 2003 filing submitting the Ninety-Seventh Agreement Amending New England Power Pool Agreement, which NEPOOL states updates and corrects certain information in section 25D of the Restated NEPOOL Open Access Transmission Tariff and in Attachments G and G–1 and the accompanying Addendum of the NEPOOL Tariff. NEPOOL states that the amendment is being filed to include tariff sheets that were inadvertently omitted from their initial filing.

NEPOOL states that copies of these materials were sent to the NEPOOL Participants, Non-Participant Transmission Customers and the and the New England state governors and regulatory commissions.

Comment Date: August 11, 2003.

7. Pacific Gas and Electric Company

[Docket No. ER03–1091–000]

Take notice that on July 21, 2003, Pacific Gas and Electric Company (PG&E) tendered for filing Generator Special Facilities Agreements (GSFAs) and Generator Interconnection Agreements (GIAs) between PG&E and the following parties: Wellhead Power Panoche, LLC (Wellhead Panoche); Wellhead Power Gates, LLC (Wellhead Gates); CalPeak Power—Vaca Dixon, LLC (CalPeak Vaca Dixon); High Winds, LLC (High Winds); Energy Transfer—Hanover Ventures, LP (Hanover); and Duke Energy Morro Bay LLC (Duke Morro Bay) PG&E has requested certain waivers. PG&E states that copies of this filing have been served upon Wellhead Panoche, Wellhead Gates, CalPeak Vaca Dixon, High Winds, Hanover, Duke Morro Bay, the California Independent System Operator Corporation and the CPUC.

Comment Date: August 11, 2003.

8. Southern California Edison Company

[Docket No. ER03–1093–000]

Take notice that on July 21, 2003, Southern California Edison Company (SCE), tendered for filing a Service Agreement For Wholesale Distribution Service under SCE's Wholesale Distribution Access Tariff and an Interconnection Facilities Agreement (Agreements) between SCE and the City of Rancho Cucamonga (Rancho Cucamonga), California. SCE requests the Agreements become effective on July 22, 2003.

SCE states that the Agreements specify the terms and conditions under which SCE will provide wholesale Distribution Service from the California Independent System Operator Controlled Grid at the Etiwanda Generating Station 220 kV bus to a new 66 kV substation to be located at the northeast corner of Rochester Avenue and Stadium Parkway in the City of Rancho Cucamonga.

SCE states that copies of this filing were served upon the Public Utilities Commission of the State of California and Corona.

Comment Date: August 11, 2003.

9. Southern California Edison Company

[Docket Nos. ER03–1094–000 and EL03–214–000]

Take notice that on July 21, 2003, Southern California Edison Company (SCE) tendered for filing a Petition for Declaratory Order and Request for Expedited Treatment, or, in the Alternative, Filing a New Tariff for Scheduling Coordinator Service under section 205 of the Federal Power Act. SCE seeks a declaratory order from the Federal Energy Regulatory Commission (FERC) declaring that SCE is not obligated to serve as Scheduling Coordinator for Los Angeles Department of Water and Power (LADWP) under the Los Angeles-Edison Exchange Agreement. In the alternative, SCE requests that FERC accept, pursuant to section 205 of the Federal Power Act, the Southern California Edison Scheduling Coordinator Services Tariff filed concurrently. The tariff proposes to pass-through the ISO charges incurred in providing scheduling coordinator service under the tariff.

SCE states that copies of this filing were served upon the Public Utilities Commission of the State of California and LADWP.

Comment Date: August 11, 2003.

10. PacifiCorp

[Docket No. ER03–1095–000]

Take notice that on July 21, 2003, PacifiCorp, tendered for filing in accordance with 18 CFR 35 of the Commission's Rules and Regulations, PacifiCorp's First Revised FERC Rate Schedule No. 306, the amended Long-Term Power Transactions Agreement between PacifiCorp and Arizona Public Service Company.

PacificCorp states that copies of this filing were supplied to the Public Utility Commission of Oregon and the Washington Utilities and Transportation Commission.

Comment Date: August 11, 2003.

11. Megawatt Marketing, LLC

[Docket No. ER03–1096–000]

Take notice that on July 21, 2003, Megawatt Marketing, LLC (Megawatt Marketing) submitted for filing a Notice of Cancellation of it market-based rate tariff.

Megawatt Marketing states that it has not used the market-based rate authority and does not foresee entering into contracts to sell power or engage in wholesale electric power and energy purchases and sales as a marketer.

Comment Date: August 11, 2003.

12. Northeast Utilities Service Company

[Docket No. ER01–1261–001]

Take notice that on July 21, 2003, the Northeast Utilities Service Company (NUSCO) on behalf of The Connecticut Light and Power Company (CL&P), filed for acceptance an executed Licensing, Engineering and Construction Agreement and an executed Interconnection and Operating Agreement between CL&P and Milford Power Company LLC (Milford), each relating to the interconnection of Milford's 560 MW combined cycle power plant to CL&P's transmission system (the Agreements).

NUSCO states that a copy of this filing has been mailed to Milford. NUSCO has requested a July 21, 2003 effective date for the Agreements, and has requested any waivers of the Commission's regulations that may be necessary to permit such an effective date.

Comment Date: August 11, 2003.

13. Fall River Rural Electric Cooperative, Inc.

[Docket No. ES03–40–000]

Take notice that on July 18, 2003, Fall River Rural Electric Cooperative, Inc. (Fall River) submitted an application pursuant to section 204 of the Federal Power Act seeking authorization to borrow no more than $13,769,232 under a master loan agreement with the National Rural Utilities Cooperative Finance Corporation.

Fall River also requests a waiver from the Commission's competitive bidding and negotiated placement requirements at 18 CFR 34.2.

Comment Date: August 13, 2003.

Standard Paragraph

Any person desiring to intervene or to protest this filing should file with the Federal Energy Regulatory Commission, 888 First Street, NE., Washington, DC 20426, in accordance with Rules 211 and 214 of the Commission's Rules of Practice and Procedure (18 CFR 385.211 and 385.214). Protests will be considered by the Commission in determining the appropriate action to be taken, but will not serve to make protestants parties to the proceeding. Any person wishing to become a party must file a motion to intervene. All such motions or protests should be filed on or before the comment date, and, to the extent applicable, must be served on the applicant and on any other person designated on the official service list. This filing is available for review at the Commission or may be viewed on the Commission's Web site at *http://www.ferc.gov* , using the ''FERRIS'' link. Enter the docket number excluding the last three digits in the docket number field to access the document. For assistance, please contact FERC Online Support at *FERCOnlineSupport@ferc.gov* or toll-free at (866) 208–3676, or for TTY, contact (202) 502–8659. Protests and interventions may be filed electronically via the Internet in lieu of paper; *see* 18 CFR 385.2001(a)(1)(iii) and the instructions on the Commission's Web site under the ''e-Filing'' link. The Commission strongly encourages electronic filings.

Magalie R. Salas,

Secretary.

[FR Doc. 03–19680 Filed 8–1–03; 8:45 am]

BILLING CODE 6717–01–P

DEPARTMENT OF ENERGY

Federal Energy Regulatory Commission

[Docket No. ER02–2001–000, et al.]

Electric Quarterly Reports et al.; Intent To Withdraw Market-Based Rate Authority

Issued July 28, 2003.

Before Commissioners: Pat Wood, III, Chairman; William L. Massey, and Nora Mead Brownell.

In the matter of: ER02–2001–000, ER95–1381–000, ER98–3451–000, ER94–1246–000, ER95–0878–000, ER97–1676–000, ER99–0581–000, ER97–4434–000, ER98–3934–000, ER99–1890–000, ER98–0102–000, ER99–2970–000, ER96–0924–000, ER02–0893–000, ER95–1399–000, ER96–0734–000, ER00–1530–000, ER96–1781–000, ER95–1752–000, ER01–2059–000, ER96–1631–000, ER97–3815–000, ER99–2540–000, ER96–1774–000, ER98–3006–000, ER97–3053–000, ER98–1221–000, ER01–1414–000, ER98–2232–000, ER97–4364–000, ER95–0751–000, ER98–3052–000, ER99–0823–000, ER97–4145–000, ER97–4680–000, ER97–1117–000, ER00–2535–000, ER98–2423–000, ER98–1297–000, ER96–2879–000: Electric Quarterly Reports, Alliance Strategies, American Premier Energy Corporation, Ashton Energy Corporation, Audit Pro Incorporated, Black Brook Energy Company, Business Discount Plan, Inc., Clean Air Capital Markets Corporation, Clinton Energy Management Services, Inc., Commodore Electric, Current Energy, Inc., Delta Energy Group, Direct Access Management, LP, Dorman Materials, Inc., Electech, Inc., Energy Marketing Services Inc., Energy & Steam Company, Inc., EnergyTek, Inc., Engineered Energy Systems Corporation, Enpower, Inc., Entrust Energy, LLC, Family Fiber Connection, Inc., Friendly Power Company, LLC, Full Power Corporation, Growth Unlimited Investments, Inc., K & K Resources, Inc., Keystone Energy Services, Inc., Micah Tech Industries, Inc., Northern Lights Power Company, People's Utility Corporation, PowerCom Energy & Communications Access, Inc., PowerGasSmart.com, Inc., PowerSource Corporation, River City Energy, Inc., Sigma Energy, Inc., Starghill Alternative Energy Corporation, TC Power Solutions, The New Power Company, The FURSTS Group, Inc., TransCurrent, LLC, US Energy, Inc.

1. Section 205 of the Federal Power Act (FPA), 16 U.S.C. 824d (2000); *accord* 18 CFR part 35 (2003), requires that all rates, terms and conditions of jurisdictional services be filed with the Commission. In Order No. 2001,[1] a final rule establishing revised public utility filing requirements for rates, terms and conditions of jurisdictional services,[2] the Commission required public utilities, including power marketers, to file, among other things, Electric Quarterly Reports summarizing the contractual terms and conditions in their agreements for all jurisdictional services (including market-based power sales, cost-based power sales, and transmission service) and transaction information (including rates) for short-term and long-term market-based power sales and cost-based power sales during the most recent calendar quarter. In Order No. 2001–C,[3] the Commission required utilities to file their Electric Quarterly Reports using software provided by the Commission. Commission staff review of the Electric Quarterly Report submittals has revealed that a number of utilities that previously had been granted authority to sell power at market-based rates have failed to file Electric Quarterly Reports. Accordingly, this order notifies those utilities that their market-based rate authorizations will be withdrawn unless they comply with the Commission's requirements.

2. In Order No. 2001, the Commission stated that, [i]f a public utility fails to file a[n] Electric Quarterly Report (without an appropriate request for extension), or fails to report an agreement in a report, that public utility may forfeit its market-based rate authority and may be required to file a new application for market-based rate authority if it wishes to resume making sales at market-based rates.[4]

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[1] Revised Public Utility Filing Requirements, Order No. 2001, 67 FR 31043, FERC Stats. & Regs. ¶ 31,127 (April 25, 2002), *reh'g denied,* Order No. 2001–A, 100 FERC ¶ 61,074, *reconsideration and clarification denied,* Order No.2001–B, 100 FERC ¶ 61,342, *order directing filings,* Order No. 2001–C, 101 FERC ¶ 61,314 (2002).

[2] Order No. 2001, FERC Stats. & Regs. ¶ 31,127 at P 11–12, 18–21.

[3] Order No. 2001–C, 101 FERC ¶ 61,314 at P 9.

[4] Order No. 2001, FERC Stats. & Regs. ¶ 31,127 at P 222.

3. The Commission further stated that, [t]he Electric Quarterly Reports are designed to satisfy the FPA section 205(c) requirements. For power marketers, the Electric Quarterly Report is intended to replace the current filing of Quarterly Transaction Reports summarizing their market-based rate transactions and the filing of long-term agreements. Electric Quarterly Reports are also intended to replace the Quarterly Transaction Reports and rate filings required of traditional utilities with market-based rate authority. Once this rule becomes effective, the requirement to comply with this rule will supersede the conditions in public utilities' market-based rate authorizations and failure to comply with the requirements of this rule will subject public utilities to the same consequences they would face for not satisfying the conditions in their rate authorizations, including possible revocation of their authority to make wholesale power sales at market-based rates.[5]

4. Commission staff has determined that a number of public utilities that had been granted market-based rate authority have failed to file their Electric Quarterly Reports.[6] Commission staff has made a concerted effort to contact non-filing utilities in writing and by phone to inform them of their regulatory obligation. Moreover, on April 24, 2003, the Secretary of the Commission sent letters to 423 companies reminding them that they were required to file the Electric Quarterly Report. The letters stated: [w]ithin thirty (30) days of the date of this letter, your company utility must file Electric Quarterly Reports for the 2nd, 3rd, and 4th Quarters of 2002 and the 1st Quarter of 2003. Failure to do so may result in the Commission's revocation of your market-based rate authority in accordance with Order No. 2001. * * * Please provide your immediate attention to this important compliance matter.[7]

5. Each of the public utilities listed in the caption of this order was sent this letter but none of them responded. In some cases, the letters were returned unopened. Commission staff called the contacts identified in its power marketer rolls and searched Commission records and the Internet to identify alternate addresses and contacts. Where an alternate address or contact could be identified, a second letter was sent. These letters also received no response.[8]

6. Notwithstanding efforts to find the non-filing public utilities listed in the caption of this order to remind them of their filing obligations, they have not complied with the requirement to file Electric Quarterly Reports.

7. Accordingly, the market-based rate authorizations for those utilities identified in the caption of this order will be withdrawn unless they comply with the Commission's requirements.

The Commission Orders

(A) Within 30 days of the date of issuance of this order, each public utility listed in the caption of this order shall file its Electric Quarterly Reports for the 2nd, 3rd, and 4th Quarters of 2002 and the 1st and 2nd Quarters of 2003. If no such filings are made, the Commission will withdraw the public utility's authority to sell power at market-based rates and terminate its electric market-based rate tariff.

(B) The Secretary is hereby directed to publish this order in the **Federal Register**.

By the Commission.

Magalie R. Salas,

Secretary.

[FR Doc. 03–19703 Filed 8–1–03; 8:45 am]

BILLING CODE 6717–01–P

[5] *Id.* at P 223.

[6] In many cases, the utilities had previously failed to file Power Marketer Quarterly Reports (the predecessor to the Electric Quarterly Reports).

[7] Letter informing Abacus Group Ltd, *et al.*, that to date their Electric Quarterly Reports had not been filed and requesting that the reports for the 2nd, 3rd, and 4th quarters of 2002, *et al.*, be filed within 30 days (April 24, 2003).

[8] These public utilities appear to have failed to update their addresses with the Secretary as required in the Commission's regulations, 18 CFR 385.2010(i)(2) (2003). In some cases, they may have gone out of business and failed to file a Notice of Cancellation of their electric market-based rate tariff with the Commission. *See* 18 CFR 35.15 (2003).

ENVIRONMENTAL PROTECTION AGENCY

[OECA–2003–0090; FRL–7539–1]

Agency Information Collection Activities; Submission to OMB for Review and Approval; Comment Request; NESHAP for Secondary Aluminum Production (40 CFR Part 63, Subpart RRR), EPA ICR Number 1894.04, OMB Control Number 2060–0433

AGENCY: Environmental Protection Agency (EPA).

ACTION: Notice.

SUMMARY: In compliance with the Paperwork Reduction Act (44 U.S.C. 3501 *et seq.*), this document announces that an Information Collection Request (ICR) has been forwarded to the Office of Management and Budget (OMB) for review and approval. This is a request to renew an existing approved collection. This ICR is scheduled to expire on July 31, 2003. Under OMB regulations, the Agency may continue to conduct or sponsor the collection of information while this submission is pending at OMB. This ICR describes the nature of the information collection and its estimated burden and cost.

DATES: Additional comments may be submitted on or before September 3, 2003.

ADDRESSES: Submit your comments, referencing docket ID number OECA–2003–0090, to (1) EPA online using EDOCKET (our preferred method), by e-mail to *docket.oeca@epa.gov,* or by mail to: EPA Docket Center, Environmental Protection Agency, Enforcement and Compliance Docket and Information Center, Mail Code 2201T, 1200 Pennsylvania Avenue, NW., Washington, DC 20460, and (2) OMB at: Office of Information and Regulatory Affairs, Office of Management and Budget (OMB), Attention: Desk Officer for EPA, 725 17th Street, NW., Washington, DC 20503.

FOR FURTHER INFORMATION CONTACT: María Malavé, Compliance Assessment and Media Programs Division (Mail Code 2223A), Office of Compliance, Environmental Protection Agency, 1200 Pennsylvania Avenue, NW., Washington, DC 20460; telephone number: (202) 564–7027; fax number: (202) 564–0050; e-mail address: *malave.maria@epa.gov.*

SUPPLEMENTARY INFORMATION: EPA has submitted the following ICR to OMB for review and approval according to the procedures prescribed in 5 CFR 1320.12. On September 26, 2002 (67 FR 60672), EPA sought comments on this ICR pursuant to 5 CFR 1320.8(d). EPA received no comments.

EPA has established a public docket for this ICR under Docket ID Number OECA–2003–0090, which is available for public viewing at the Enforcement and Compliance Docket and Information Center in the EPA Docket Center (EPA/DC), EPA West, Room B102, 1301 Constitution Avenue, NW, Washington, D.C. The EPA Docket Center Public Reading Room is open from 8:30 a.m. to 4:30 p.m., Monday through Friday, excluding legal holidays. The telephone number for the Reading Room is (202) 566–1744, and the telephone number for the Enforcement and Compliance Docket and Information Center is: (202) 566–1514. An electronic version of the public docket is available through EPA Dockets (EDOCKET) at *http://www.epa.gov/edocket.* Use EDOCKET to submit or view public comments, access the index listing of the contents of the public docket, and to access those documents in the public docket that are available electronically. Once in the system, select ''search,'' then key in the docket ID number identified above.

Any comments related to this ICR should be submitted to EPA and OMB within 30 days of this notice. EPA's policy is that public comment, whether submitted electronically or in paper, will be made available for public viewing in EDOCKET as EPA receives them and without change, unless the comment contains copyrighted material, CBI, or other information whose public disclosure is restricted by statute. When EPA identifies a comment containing copyrighted material, EPA will provide a reference to that material in the version of the comment that is placed in EDOCKET. The entire printed comment, including the copyrighted material, will be available in the public docket. Although identified as an item in the official docket, information claimed as CBI, or whose disclosure is otherwise restricted by statute, is not included in the official public docket, and will not be available for public viewing in EDOCKET. For further information about the electronic docket, see EPA's **Federal Register** notice describing the electronic docket at 67 FR 38102 (May 31, 2002), or go to *http://www.epa.gov/edocket.*

Title: NESHAP for Secondary Aluminum Production (40 CFR part 63, subpart RRR), EPA ICR Number 1894.04, OMB Control Number 2060–0433.

Abstract: The National Emission Standards for Hazardous Air Pollutants (NESHAP) for the regulations published at 40 CFR part 63, subpart RRR, were proposed on February 11, 1999, promulgated on March 23, 2002, with final rule amendments published on December 30, 2002, which addressed concerns raised from two settlements and other amendments. These regulations apply to component processes at secondary aluminum production plants that are major sources and area sources including aluminum scrap shredders, thermal chip dryers, scrap dryers/delacquering kilns/decoating kilns, secondary aluminum processing units (SAPUs) composed of in-line fluxers and process furnaces (including both melting and holding furnaces of various configurations), sweat furnaces, dross-only furnaces, and rotary dross coolers, commencing construction, or reconstruction after the date of proposal. As a result of a rule amendment in 2002, owners and operators of certain aluminum die casting facilities, aluminum foundries, and aluminum extrusion facilities were excluded from the rule coverage. Respondents do not include the owner or operator of any facility that is not a major source of (Hazardous Air Pollutants) HAP emissions except for those that are area sources of dioxin/furan emissions.

In general, all NESHAP standards require initial notifications, performance tests, and periodic reports. Owners or operators are also required to maintain records of the occurrence and duration of any startup, shutdown, or malfunction in the operation of an affected facility, or any period during which the monitoring system is inoperative. These notifications, reports, and records are essential in determining compliance, and are required of all sources subject to NESHAP.

Any owner or operator subject to the provisions of this part shall maintain a file of these measurements, and retain the file for at least five years following the date of such measurements, maintenance reports, and records. All reports are sent to the delegated State or local authority. In the event that there is no such delegated authority, the reports are sent directly to the United States Environmental Protection Agency (EPA) Regional Office.

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. The OMB control numbers for EPA's regulations are listed in 40 CFR part 9 and 48 CFR chapter 15, and are identified on the form and/or instrument, if applicable.

Burden Statement: The annual public reporting and recordkeeping burden for this collection of information is estimated to average 28 hours per response. Burden means the total time, effort, or financial resources expended by persons to generate, maintain, retain, or disclose or provide information to or for a Federal agency. This includes the time needed to review instructions; develop, acquire, install, and utilize technology and systems for the purposes of collecting, validating, and verifying information, processing and maintaining information, and disclosing and providing information; adjust the existing ways to comply with any previously applicable instructions and requirements; train personnel to be able to respond to a collection of information; search data sources; complete and review the collection of information; and transmit or otherwise disclose the information.

Respondents/Affected Entities: Component processes at secondary aluminum production plants that are major sources and area sources including aluminum scrap shredders, thermal chip dryers, scrap dryers/delacquering kilns/decoating kilns, secondary aluminum processing units composed of in-line fluxers and process furnaces (including both melting and holding furnaces of various configurations), sweat furnaces, dross-only furnaces, and rotary dross coolers

Estimated Number of Respondents: 1,640.

Frequency of Response: initial, semiannual and on occasion.

Estimated Total Annual Hour Burden: 94,998 hours.

Estimated Total Capital and Operations & Maintenance (O & M) Annual Costs: $230,550 which includes $88,800 annualized capital/startup costs and $141,750 annual O&M costs.

Changes in the Estimates: There is a decrease of 25,230 hours in the total estimated burden currently identified in the OMB Inventory of Approved ICR Burdens. This decrease in burden is due to a decrease in the number of existing major sources from 86 to 81 and the assumption that existing sources already comply with the initial requirements of the rule. In addition, although we expect an increase of approximately 5 percent in the number of new sweat furnaces (74) during the next three years, based on information from manufacturers, the burden associated with this increase will be offset by a decrease of approximately 10 percent in the number of existing sweat furnaces (149) which are anticipated to close due to no longer being economically viable. New sources (*i.e.*, sweat furnaces) will be subject only to the dioxins/furans requirements of the rule which also accounts for a reduction in the monitoring, recordkeeping and reporting requirements.

Dated: July 25, 2003.

Doreen Sterling,

Acting Director, Collection Strategies Division.

[FR Doc. 03–19742 Filed 8–1–03; 8:45 am]

BILLING CODE 6560–00–P

ENVIRONMENTAL PROTECTION AGENCY

[SFUND–2003–0004; FRL–7538–9]

Agency Information Collection Activities; Submission of EPA ICR No. 2104.01 to OMB for Review and Approval; Comment Request

AGENCY: Environmental Protection Agency (EPA).

ACTION: Notice.

SUMMARY: In compliance with the Paperwork Reduction Act (44 U.S.C. 3501 *et seq.*), this document announces that the following Information Collection Request (ICR) has been forwarded to the Office of Management and Budget (OMB) for review and approval: Brownfields Program—Revitalization Grantee Reporting. The ICR, which is abstracted below, describes the nature of the information collection and its estimated burden and cost.

DATES: Additional comments may be submitted on or before September 3, 2003.

ADDRESSES: Follow the detailed instructions in the **SUPPLEMENTARY INFORMATION** section.

FOR FURTHER INFORMATION CONTACT: James Maas, Office of Solid Waste and Emergency Response (OSWER), Office of Brownfields Cleanup and Redevelopment (OBCR) 5105T, U.S. EPA Headquarters, Ariel Rios Building, 1200 Pennsylvania Avenue, NW., Washington, DC 20460; telephone number: (202) 566–2778; fax number: (202) 566–2757; e-mail address: *maas.james@epa.gov.*

SUPPLEMENTARY INFORMATION: EPA has submitted the following ICR to OMB for review and approval according to the procedures prescribed in 5 CFR 1320.12. On April 4, 2003, (68 FR 16508) EPA sought comments on this ICR pursuant to 5 CFR 1320.8(d). EPA received two comments in response to this notice. One comment addressed reporting provisions under the Agency's general assistance regulations at 40 CFR parts 30 and 31, and does not pertain to the reporting requirements under this ICR. The other comment stated that grantee burden would be reduced through electronic reporting. EPA agrees with the commenter and, as addressed in the supporting statement to the ICR, is planning to provide grantees the option of providing reports electronically. In addition, EPA has determined that information that was to be collected using the Brownfields Budget Profile Form will be collected on an existing, OMB-approved grants form; therefore, the Brownfields form and its associated burden have been eliminated from this ICR.

EPA has established a public docket for this ICR under Docket ID No. SFUND–2003–0004, which is available for public viewing at the Superfund Docket in the EPA Docket Center (EPA/DC), EPA West, Room B102, 1301 Constitution Ave., NW., Washington, DC. The EPA Docket Center Public Reading Room is open from 8:30 a.m. to 4:30 p.m., Monday through Friday, excluding legal holidays. The telephone number for the Reading Room is (202) 566–1744, and the telephone number for the Superfund Docket is (202) 566–0276. An electronic version of the public docket is available through EPA Dockets (EDOCKET) at *http://www.epa.gov/edocket.* Use EDOCKET to submit or view public comments, access the index listing of the contents of the public docket, and to access those documents in the public docket that are available electronically. Once in the system, select ''search,'' then key in the docket ID number identified above.

Any comments related to this ICR should be submitted to EPA and OMB within 30 days of this notice, and according to the following detailed instructions: (1) Submit your comments to EPA online using EDOCKET (our preferred method), by e-mail to *superfund.docket@epa.gov,* or by mail to: EPA Docket Center, Environmental Protection Agency, Superfund Docket, Mail Code: 5202T, 1200 Pennsylvania Ave., NW., Washington, DC 20460, and (2) Mail your comments to OMB at: Office of Information and Regulatory Affairs, Office of Management and Budget (OMB), Attention: Desk Officer for EPA, 725 17th Street, NW., Washington, DC 20503.

EPA's policy is that public comments, whether submitted electronically or in paper, will be made available for public viewing in EDOCKET as EPA receives them and without change, unless the comment contains copyrighted material, CBI, or other information whose public disclosure is restricted by statute. When EPA identifies a comment containing copyrighted material, EPA will provide a reference to that material in the version of the comment that is placed in EDOCKET. The entire printed comment, including the copyrighted material, will be available in the public docket. Although identified as an item in the official docket, information claimed as CBI, or whose disclosure is otherwise restricted by statute, is not included in the official public docket, and will not be available for public viewing in EDOCKET. For further information about the electronic docket, see EPA's **Federal Register** notice describing the electronic docket at 67 FR 38102 (May 31, 2002), or go to *www.epa.gov/edocket.*

Title: Brownfields Program—Revitalization Grantee Reporting, (EPA ICR Number 2104.01). This is a request for a new information collection. Under OMB regulations, the Agency may continue to conduct or sponsor the collection of information while this submission is pending at OMB.

Abstract: The Small Business Liability Relief and Brownfields Revitalization Act (Pub. L. 107–118) (''the Brownfields Amendments'') was signed into law on January 11, 2002. The Act amends the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), as amended, and authorizes EPA to award grants to states, tribes, local governments, and other eligible entities to assess and clean up brownfields sites. Under the Brownfields Amendments, a brownfields site means real property, the expansion, redevelopment, or reuse of which may be complicated by the presence or potential presence of a hazardous substance, pollutant, or contaminant. For grant funding purposes, EPA uses the term ''brownfields property(ies)'' synonymously with the term ''brownfields sites.'' The Brownfields Amendments authorize EPA to award several types of grants to eligible entities on a competitive basis. Under subtitle A of the Small Business Liability Relief and Brownfields Revitalization Act, states, tribes, local governments, and other eligible entities can receive assessment grants to inventory, characterize, assess, and conduct planning and community involvement related to brownfields properties; cleanup grants to carry out cleanup activities at brownfields properties; grants to capitalize revolving loan funds and provide subgrants for cleanup activities; and job training grants to support the creation and implementation of environmental job training and placement programs.

Grant recipients have general reporting and record keeping requirements as a condition of their grant that result in burden. A portion of this reporting and record keeping burden is authorized under 40 CFR parts 30 and 31 and identified in the EPA's general grants ICR (OMB Control Number 2030–0020). EPA requires Brownfields program grant recipients to maintain and report additional information to EPA on the uses and accomplishments associated with the funded brownfields activities. EPA has prepared several forms to assist grantees in reporting the information and to ensure consistency of the information collected. EPA will use this information to meet Federal stewardship responsibilities to manage and track how program funds are being spent, to evaluate the performance of the Brownfields Cleanup and Redevelopment Program, to meet the Agency's reporting requirements under the Government Performance Results

Act, and to report to Congress and other program stakeholders on the status and accomplishments of the grants program. This ICR addresses the burden imposed on grant recipients that are associated with those reporting and recordkeeping requirements that are specific to grants awarded under Subtitle A of the Small Business Liability Relief and Brownfields Revitalization Act. This ICR does not address the burden imposed on grant recipients who are awarded grants under Subtitle C of the Small Business Liability Relief and Brownfields Revitalization Act.

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. The OMB control numbers for EPA's regulations are listed in 40 CFR part 9 and 48 CFR chapter 15, and are identified on the form and/or instrument, if applicable.

Burden Statement: The annual public reporting and recordkeeping burden for this collection of information is estimated to average 5 hours per response for job training grant recipients, and 1.25 hours per response for assessment, cleanup, and revolving loan fund grant recipients. Burden means the total time, effort, or financial resources expended by persons to generate, maintain, retain, or disclose or provide information to or for a Federal agency. This includes the time needed to review instructions; develop, acquire, install, and utilize technology and systems for the purposes of collecting, validating, and verifying information, processing and maintaining information, and disclosing and providing information; adjust the existing ways to comply with any previously applicable instructions and requirements; train personnel to be able to respond to a collection of information; search data sources; complete and review the collection of information; and transmit or otherwise disclose the information.

Respondents/Affected Entities: Entities potentially affected by this action are states, tribes, local governments, and certain non-governmental organizations that apply for and receive grants from EPA to support the cleanup and redevelopment of brownfields properties.

Estimated Number of Respondents: 203.

Frequency of Response: Quarterly.

Estimated Total Annual Hour Burden: 7,320.

Estimated Total Annual Capital and Operations and Maintenance Cost: $0.

Changes in the Estimates: This is a new ICR and the estimated burden represents an increase to the total estimated burden currently identified in the OMB Inventory of Approved ICR Burdens.

Dated: July 24, 2003.

Doreen Sterling,

Acting Director, Collection Strategies Division.

[FR Doc. 03–19743 Filed 8–1–03; 8:45 am]

BILLING CODE 6560–50–P

ENVIRONMENTAL PROTECTION AGENCY

[OAR–2003–0145, FRL–7539–7]

Agency Information Collection Activities: Proposed Collection; Comment Request; Production Line Testing, In-use Testing, and Selective Enforcement Auditing Reporting and Recordkeeping Requirements for Manufacturers of Nonroad Spark Ignition Engines At or Below 19 Kilowatts, EPA ICR Number 1845.03, OMB Control Number 2060–0427

AGENCY: Environmental Protection Agency (EPA).

ACTION: Notice.

SUMMARY: In compliance with the Paperwork Reduction Act (44 U.S.C. 3501 *et seq.*), this document announces that EPA is planning to submit a continuing Information Collection Request (ICR) to the Office of Management and Budget (OMB). This is a request to renew an existing approved collection. This ICR is scheduled to expire on 10/31/2003. Before submitting the ICR to OMB for review and approval, EPA is soliciting comments on specific aspects of the proposed information collection as described below.

DATES: Comments must be submitted on or before October 3, 2003.

ADDRESSES: Submit your comments, referencing docket ID number OAR–2003–0145, to EPA online using EDOCKET (our preferred method), by e-mail to *a-and-r-docket@epamail.epa.gov*, or by mail to: EPA Docket Center, Environmental Protection Agency, Air and Radiation Docket and Information Center, Mail Code 6102T, 1200 Pennsylvania Ave., NW., Washington, DC 20460.

FOR FURTHER INFORMATION CONTACT: Ms. Nydia Y. Reyes-Morales, Mail Code 6403J, Environmental Protection Agency, 1200 Pennsylvania Ave., NW., Washington, DC 20460; telephone number: 202–564–9264; fax number: 202–565–2057; e-mail address: *reyes-morales.nydia@epa.gov*.

SUPPLEMENTARY INFORMATION: EPA has established a public docket for this ICR under Docket ID number OAR–2003–0145, which is available for public viewing at the Air and Radiation Docket in the EPA Docket Center (EPA/DC), EPA West, Room B102, 1301 Constitution Ave., NW., Washington, DC. The EPA Docket Center Public Reading Room is open from 8:30 a.m. to 4:30 p.m., Monday through Friday, excluding legal holidays. The telephone number for the Reading Room is (202) 566–1744, and the telephone number for the Air and Radiation Docket is (202) 566–1742. An electronic version of the public docket is available through EPA Dockets (EDOCKET) at *http://www.epa.gov/edocket*. Use EDOCKET to obtain a copy of the draft collection of information, submit or view public comments, access the index listing of the contents of the public docket, and to access those documents in the public docket that are available electronically. Once in the system, select ''search,'' then key in the docket ID number identified above.

Any comments related to this ICR should be submitted to EPA within 60 days of this notice. EPA's policy is that public comments, whether submitted electronically or in paper, will be made available for public viewing in EDOCKET as EPA receives them and without change, unless the comment contains copyrighted material, confidential business information (CBI), or other information whose public disclosure is restricted by statute. When EPA identifies a comment containing copyrighted material, EPA will provide a reference to that material in the version of the comment that is placed in EDOCKET. The entire printed comment, including the copyrighted material, will be available in the public docket. Although identified as an item in the official docket, information claimed as CBI, or whose disclosure is otherwise restricted by statute, is not included in the official public docket, and will not be available for public viewing in EDOCKET. For further information about the electronic docket, *see* EPA's **Federal Register** notice describing the electronic docket at 67 FR 38102 (May 31, 2002), or go to *http://www.epa.gov./edocket*.

Affected entities: Entities potentially affected by this action are manufacturers of spark ignition engines rated at or below 19 kilowatts.

Title: Production Line Testing, In-use Testing, and Selective Enforcement Auditing Reporting and Recordkeeping Requirements for Manufacturers of Nonroad Spark Ignition Engines At or Below 19 Kilowatts.

Abstract: Title II of the Clean Air Act requires engine manufacturers to obtain a certificate of conformity with applicable emission standards for each engine prototype before they may legally introduced their products into commerce. The Act also mandates EPA to verify that manufacturers have successfully translated their certified engine prototypes into mass produced engines and that these engines comply with emission standards throughout their useful lives. Under the Production Line Testing (PLT) Program, manufacturers test a sample of engines as they leave the assembly line. This self-audit program allows manufacturers to monitor compliance with statistical certainty and minimize the cost of correcting errors through early detection. Under the Voluntary In-use Testing Program, manufacturers test engines after a number of years of use to verify that the engines comply with emission standards throughout their useful lives. Under the spark ignition engine emissions rule, codified at 40 CFR part 90, only Phase 2 SI engines are elegible to participate in the PLT and the In-use Programs. Engine manufacturers can choose to participate in either the PLT Program or the In-use Program.

Sections 206(b) and 213(d) of the Act also mandate that EPA conduct testing of a sample of certified engines to determine if these engines do in fact conform with the applicable emission regulations. Under the Selective Enforcement Audit (SEA) Program, EPA selects a number of engines to be taken directly from the assembly line and tested according to EPA specifications. These audits are performed to ensure that test data submitted by manufacturers is reliable and testing is performed according to EPA regulations. All SI engine manufacturers are subject to be audited. Participation in the SEA program is mandatory.

The information requested by this information collection is used to enforce different provisions of the Act and maintain the integrity of the overall emissions reduction program. Data generated through the PLT, In-use and SEA programs may be used to evaluate future applications for certification, to identify potential issues, and as basis to suspend or revoke the certificate of conformity of those engines that fail. There are recordkeeping requirements in all programs.

The information is collected by the Engine Programs Group, Certification and Compliance Division, Office of Transportation and Air Quality, Office of Air and Radiation. Confidentiality of proprietary information submitted by manufacturers is granted in accordance with the Freedom of Information Act, EPA regulations at 40 CFR part 2, and class determinations issued by EPA's Office of General Counsel. 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. The OMB control numbers for EPA's regulations in 40 CFR are listed in 40 CFR part 9.

The EPA would like to solicit comments to:

(i) 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;

(ii) Evaluate the accuracy of the Agency's estimate of the burden of the proposed collection of information, including the validity of the methodology and assumptions used;

(iii) Enhance the quality, utility, and clarity of the information to be collected; and

(iv) Minimize the burden of the collection of information on those who are to respond, including through the use of appropriate automated electronic, mechanical, or other technological collection techniques or other forms of information technology, *e.g.*, permitting electronic submission of responses.

TABLE I.—BURDEN STATEMENT

	PLT	In-use	SEA
Estimated Total Burden Hours	6,709	1,410	1,056
Estimated Average Burden Hours/Response	1,677	705	528
Frequency of Response	Quarterly	On occasion	On occasion
Number of Respondents	5	2	2
Total Annual Cost (Industry-wide)	$1,129,021	$54,927	$36,907
Total Annual Capital and Start Up Cost	0	0	0
Total Annual Operation and Maintenance Costs	$14,170	$3,260	$480

Burden means the total time, effort, or financial resources expended by persons to generate, maintain, retain, or disclose or provide information to or for a Federal agency. This includes the time needed to review instructions; develop, acquire, install, and utilize technology and systems for the purposes of collecting, validating, and verifying information, processing and maintaining information, and disclosing and providing information; adjust the existing ways to comply with any previously applicable instructions and requirements; train personnel to be able to respond to a collection of information; search data sources; complete and review the collection of information; and transmit or otherwise disclose the information.

Dated: July 23, 2003.

Robert Brenner,

Acting Assistant Administrator, Office of Air and Radiation.

[FR Doc. 03–19747 Filed 8–1–03; 8:45 am]

BILLING CODE 6560–50–P

ENVIRONMENTAL PROTECTION AGENCY

[FRL–7538–7]

Advisory Committee for Regulatory Negotiation Concerning All Appropriate Inquiry; Meeting

AGENCY: Environmental Protection Agency (EPA).

ACTION: Notice.

SUMMARY: The Environmental Protection Agency, as required by the Federal Advisory Committee Act (Pub. L. 92–463), is announcing the date and location of an upcoming meeting of the Negotiated Rulemaking Committee On All Appropriate Inquiry.

DATES: A meeting of the Federal Advisory Committee on Regulatory Negotiation for All Appropriate Inquiry is scheduled for September 9 and September 10, 2003. The meeting will take place at the EPA East Building, 1201 Constitution Avenue NW., Washington, DC 20460. The meeting is scheduled to begin at 8:30 a.m. and end at 4:30 p.m. on both days. Dates and locations of subsequent meetings will be announced in later notices.

FOR FURTHER INFORMATION CONTACT: Persons needing further information should contact Patricia Overmeyer of EPA's Office of Brownfields Cleanup and Redevelopment, 1200 Pennsylvania Ave., NW., Mailcode 5105T, Washington, DC 20460, (202) 566–2774, or *overmeyer.patricia@epa.gov.*

SUPPLEMENTARY INFORMATION: Under the Small Business Liability Relief and Brownfields Revitalization Act, EPA is required to develop standards and practices for carrying out all appropriate inquiry. The Federal Advisory Committee meeting is for the purpose of negotiating the contents of a proposed regulation setting federal standards and practices for conducting all appropriate inquiry. At its meeting on September 9 and 10, 2003, the Committee will continue substantive deliberations on the proposed rulemaking including discussion of the criteria established by Congress in the Small Business Liability Relief and Brownfields Revitalization Act amendments to CERCLA (101)(35)(B)(iii). On the morning of September 9, 2003, there will be a presentation to the Committee on the administrative and analytical requirements that must be completed by the Agency when developing a proposed rule.

All meetings of the Negotiated Rulemaking Committee are open to the public. There is no requirement for advance registration for members of the public who wish to attend or make comments at the meeting. Opportunity for the general public to address the Committee will be provided starting at 2:30 p.m. on both September 9 and September 10, 2003.

Dated: July 28, 2003.

Thomas P. Dunne,

Associate Assistant Administrator, Office of Solid Waste and Emergency Response.

[FR Doc. 03–19745 Filed 8–1–03; 8:45 am]

BILLING CODE 6560–50–P

ENVIRONMENTAL PROTECTION AGENCY

[FRL–7538–6]

Draft Brownfield Grants Guidelines

AGENCY: Environmental Protection Agency.

ACTION: Notice of public meeting.

SUMMARY: The Environmental Protection Agency (EPA) is holding a public meeting to discuss EPA's draft of the fiscal year 2004 Proposal Guidelines for Brownfields Assessment, Revolving Loan Fund, and Cleanup Grants (Brownfield Grants Guidelines). The purpose of the public meeting is for EPA's Office of Brownfields Cleanup and Redevelopment to listen to the views of public stakeholders on the Agency's draft Brownfield Grants Guidelines. During the public meeting, EPA officials will discuss the draft Guidelines. EPA will make the draft Brownfield Grants Guidelines available to the public on the Agency's Web site at *http://www.epa.gov/brownfields* on August 25, 2003. Interested stakeholders and the public are encouraged to download and review the draft guidelines prior to the public meeting.

DATES: The public meeting will be held from 10 a.m.–12 noon on September 8, 2003.

ADDRESSES: The public meeting will be held in Room 1153 EPA East Building at 1201 Constitution Avenue, NW, Washington, DC. Those parties that wish to submit written comments on the draft Brownfield Grants Guidelines must submit their comments to EPA no later than September 8, 2003. To ensure that EPA has adequate time to consider any written comments, the Agency encourages parties to submit their comments to the Agency in electronic format. Electronic comments may be submitted to EPA's Office of Brownfields Cleanup and Redevelopment at *bf.comments@epa.gov.* Parties wishing to submit their comments via the United States Postal Service should address their comments to: Ms. Becky Brooks, U.S. Environmental Protection Agency, Office of Brownfields Cleanup and Redevelopment, MC–5105T, 1200 Pennsylvania Avenue, NW, Washington, DC 20460. Hand deliveries should be sent to Ms. Becky Brooks, U.S. Environmental Protection Agency, Office of Brownfields Cleanup and Redevelopment, Room 2406, 1301 Constitution Avenue, NW, Washington, DC 20460.

FOR FURTHER INFORMATION CONTACT: For additional information, contact EPA's Office of Brownfields Cleanup and Redevelopment at 202–566–2777.

SUPPLEMENTARY INFORMATION: The FY2004 Brownfield Grants Guidelines will be issued under section 104(k) of the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) as amended by the Small Business Liability Relief and Brownfields Revitalization Act, Public Law 107–118 (SBLRBRA). Guidelines for grant programs are exempt from notice and comment requirements under 5 U.S.C. 553(a)(2). However, the Agency has decided that consultation with public stakeholders prior to issuing the final version of the Brownfield Grants Guidelines is an appropriate step in effectively implementing the Brownfields Law.

The meeting is open to the general public. Parties wishing to provide their views to EPA on the draft FY04 Guidelines, or to listen to the views of other parties, are strongly encouraged to attend the public meeting. Interested parties not able to attend the public meeting on September 8, 2003, may submit written comments to the Agency. All written comments must be received by the Agency no later than September 8, 2003. The Agency will carefully consider comments received during the public meeting, as well as written comments received on or before September 8, 2003, prior to issuing final Brownfield Grants Guidelines in September 2003. However, due to the need to provide the final Guidelines to potential applicants promptly, EPA does not plan to respond in writing to written comments.

Dated: July 28, 2003.

Linda Garczynski,

Director, Office of Brownfields Cleanup and Redevelopment.

[FR Doc. 03–19746 Filed 8–1–03; 8:45 am]

BILLING CODE 6560–50–P

ENVIRONMENTAL PROTECTION AGENCY

[FRL–7538–8]

Final Reissuance of the National Pollutant Discharge Elimination System (NPDES) Storm Water Construction General Permit for the Commonwealth of Massachusetts and Indian Country in Massachusetts

AGENCY: Environmental Protection Agency (EPA).

ACTION: Notice of Final Reissuance of NPDES Storm Water Construction General Permits.

SUMMARY: This action provides notice of the reissuance of the Final National Pollutant Discharge Elimination System (NPDES) Storm Water Construction General Permit for the Commonwealth of Massachusetts and Indian country within the Commonwealth of Massachusetts.

DATES: Today's action shall be effective August 4, 2003. The permit will expire five years from the effective date.

ADDRESSES: The final permit is based on an administrative record. The administrative record for the final construction general permit is available for inspection and copying at the Water Docket, located at the EPA Docket Center in the basement of the EPA West

Building, Room B–102, at 1301 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Additional information concerning the final permit, the permit's Notice of Intent (NOI), or the permit's Notice of Termination (NOT) is available on EPA's Web site at *http://www.epa.gov/npdes/stormwater/cgp.cfm* or from Thelma Murphy, Office of Ecosystem Protection, Environmental Protection Agency, 1 Congress Street, Suite 1100, Boston, MA 02114–2023; telephone: 617–918–1615; e-mail: *murphy.thelma@epa.gov.*

SUPPLEMENTARY INFORMATION:

I. General Information

On July 1, 2003 (68 FR 39087), EPA published final NPDES construction general permits for large construction activity in Regions 1, 2, 3, 6, 7, 8, 9 and 10. Also on July 1, 2003 (68 FR 39087), EPA published final NPDES construction general permits for small construction activity in Regions 1, 2, 3, 5, 6, 7, 8, 9, and 10. At the time of publication, the State Coastal Zone Management Act certification for Massachusetts had not been received, therefore the neither the small or large construction activity general permits were issued in Massachusetts. EPA Region 1 received certification from the Office of Coastal Zone Management. The Office concurred with EPA's certification that the permit as proposed is consistent with the Coastal Zone Management enforceable program policies.

Today's action reissues EPA's NPDES General Permit for Storm Water Discharges from Construction Activities for the Commonwealth of Massachusetts and Indian country in Massachusetts. The permit's terms and conditions are those set forth in the Construction General Permit reissued on July 1, 2003 (68 FR 39087) and available at *http://www.epa.gov/npdes/stormwater/cgp.* The state specific requirements for the Commonwealth of Massachusetts, except Indian country, under section 401 of the Clean Water Act are found in part 9.A.1 of the construction general permit. The Office of Coastal Zone Management did not add any additional requirements to the permit.

Additional information regarding the statutory and regulatory history of the final permit and storm water program; significant changes to the permit; and a summary of the terms and conditions of the permit are found in the July 1, 2003 **Federal Register** and are not being repeated here.

II. Executive Order 12866

Under Executive Order 12866 (58 FR 51735 (October 4, 1993)) the Agency must determine whether the regulatory action is ''significant'' and therefore subject to OMB review and the requirements of the Executive Order. The Order defines ''significant regulatory action'' as one 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. OMB has exempted review of NPDES general permits under the terms of Executive Order 12866.

III. Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA) generally requires an agency to prepare a regulatory flexibility analysis of any rule subject to notice and comment rule-making requirements under the Administrative Procedures Act or any other statute unless the agency certifies that the rule will not have a significant economic impact on a substantial number of small entities. Small entities include small businesses, small organizations, and small governmental jurisdictions.

Issuance of an NPDES general permit is not subject to rulemaking requirements, under APA section 553 or any other law, and is thus not subject to the RFA requirements. The APA defines two broad, mutually exclusive categories of agency action—''rules'' and ''orders.'' Its definition of ''rule'' encompasses ''an agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy or describing the organization, procedure, or practice requirements of an agency * * *'' APA section 551(4). Its definition of ''order'' is residual: ''a final disposition * * * of an agency in a matter other than rule making but including licensing.'' APA section 551(6) (emphasis added). The APA defines ''license'' to ''include * * * an agency permit * * *'' APA section 551(8). The APA thus categorizes a permit as an order, which by the APA's definition is not a rule. Section 553 of the APA establishes ''rule making'' requirements. The APA defines ''rule making'' as ''the agency process for formulating, amending, or repealing a rule.'' APA section 551(5). By its terms, then, section 553 applies only to ''rules'' and not also to ''orders,'' which include permits.

IV. Unfunded Mandates Reform Act

Title II of the Unfunded Mandates Reform Act of 1995 (UMRA), Public Law 104–4, establishes requirements for Federal agencies to assess the effects of their ''regulatory actions'' on State, local, and tribal governments and the private sector. UMRA uses the term ''regulatory actions'' to refer to regulations. (*See, e.g.*, UMRA section 201, ''Each agency shall * * * assess the effects of Federal regulatory actions * * * (other than to the extent that such regulations incorporate requirements specifically set forth in law)'' (emphasis added)). UMRA section 102 defines ''regulation'' by reference to 2 U.S.C. 658 which in turn defines ''regulation'' and ''rule'' by reference to section 601(2) of the Regulatory Flexibility Act (RFA). That section of the RFA defines ''rule'' as ''any rule for which the agency publishes a notice of proposed rulemaking pursuant to section 553(b) of [the Administrative Procedure Act (APA)], or any other law. * * *'' As discussed in the RFA section of this notice, NPDES general permits are not ''rules'' under the APA and thus not subject to the APA requirement to publish a notice of proposed rulemaking. NPDES general permits are also not subject to such a requirement under the CWA. While EPA publishes a notice to solicit public comment on draft general permits, it does so pursuant to the CWA section 402(a) requirement to provide ''an opportunity for a hearing.'' Thus, NPDES general permits are not ''rules'' for RFA or UMRA purposes.

V. Paperwork Reduction Act

EPA has reviewed the requirements imposed on regulated facilities resulting from the final construction general permit under the Paperwork Reduction Act of 1980, 44 U.S.C. 3501 *et seq.* The information collection requirements of the construction general permit for large construction activities have already been approved by the Office of Management and Budget (OMB) (OMB Control No. 2040–0188) in previous submissions made for the NPDES permit program under the provisions of the Clean Water Act. Information collection requirements of the construction general permit for small construction activities were submitted to OMB (OMB Control No. 2040–0211) for review and approval and will be published in a separate **Federal Register** Notice.

Authority: Clean Water Act, 33 U.S.C. 1251 *et seq.*

Dated: July 16, 2003.

Linda M. Murphy,

Director, Office of Ecosystem Protection.

[FR Doc. 03–19744 Filed 8–1–03; 8:45 am]

BILLING CODE 6560–50–P

ENVIRONMENTAL PROTECTION AGENCY

[FRL–7539–2]

Clean Water Act Section 303(d): Availability of 5 Total Maximum Daily Loads (TMDLs)

AGENCY: Environmental Protection Agency (EPA).

ACTION: Notice of availability.

SUMMARY: This notice announces the availability for comment of the administrative record file for 5 TMDLs and the calculations for these TMDLs prepared by EPA Region 6 for waters listed in the state of Arkansas under section 303(d) of the Clean Water Act (CWA). These TMDLs were completed in response to the lawsuit styled *Sierra Club, et al.* v. *Browner, et al.*, No. LR–C–99–114.

DATES: Comments must be submitted in writing to EPA on or before September 3, 2003.

ADDRESSES: Comments on the 5 TMDLs should be sent to Ellen Caldwell, Environmental Protection Specialist, Water Quality Protection Division, U.S. Environmental Protection Agency Region 6, 1445 Ross Ave., Dallas, TX 75202–2733, facsimile (214) 665–6490, or e-mail: *caldwell.ellen@epa.gov.* For further information, contact Ellen Caldwell at (214) 665–7513. Documents from the administrative record file for these TMDLs are available for public inspection at this address as well. Documents from the administrative record file may be viewed at *http://www.epa.gov/region6/water/artmdl.htm*, or obtained by calling or writing Ms. Caldwell at the above address. Please contact Ms. Caldwell to schedule an inspection.

FOR FURTHER INFORMATION CONTACT: Ellen Caldwell at (214) 665–7513.

SUPPLEMENTARY INFORMATION: In 1999, five Arkansas environmental groups, the Sierra Club, Federation of Fly Fishers, Crooked Creek Coalition, Arkansas Fly Fishers, and Save our Streams (plaintiffs), filed a lawsuit in Federal Court against the United States Environmental Protection Agency (EPA), styled *Sierra Club, et al.* v. Browner, *et al.*, No. LR–C–99–114. Among other claims, plaintiffs alleged that EPA failed to establish Arkansas TMDLs in a timely manner. EPA proposes these TMDLs pursuant to a consent decree entered in this lawsuit.

EPA Seeks Comment on 5 TMDLs

By this notice EPA is seeking comment on the following 5 TMDLs for waters located within the state of Arkansas:

Segment-reach	Waterbody name	Pollutant
08040201–706–16	Flat Creek	Chloride.
08040201–706–16	Flat Creek	Sulfate.
08040201–706–16	Flat Creek	TDS.
08040201–806–8	Salt Creek	Chloride.
08040201–806–8	Salt Creek	TDS.

EPA requests that the public provide to EPA any water quality related data and information that may be relevant to the calculations for these 5 TMDLs. EPA will review all data and information submitted during the public comment period and revise the TMDLs and determinations where appropriate. EPA will then forward the TMDLs to the Arkansas Department of Environmental Quality (ADEQ). The ADEQ will incorporate the TMDLs into its current water quality management plan. The EPA also will revise the Arkansas 303(d) list as appropriate.

Dated: July 24, 2003.

Miguel I. Flores,

Director, Water Quality Protection Division, Region 6.

[FR Doc. 03–19741 Filed 8–1–03; 8:45 am]

BILLING CODE 6560–50–P

FEDERAL COMMUNICATIONS COMMISSION

[CC Docket 98–67; DA 03–2409]

Notice of Certification of State Telecommunications Relay Service (TRS) Programs

AGENCY: Federal Communications Commission.

ACTION: Notice.

SUMMARY: The purpose of this document is to notify state Telecommunications Relay Service (TRS) programs that certification of their program has been granted through July 26, 2008. Notice is hereby given that the applications for certification of state Telecommunications Relay Services (TRS) programs of the states listed below have been granted, subject to the condition described below, pursuant to Title IV of the Americans with Disabilities Act (ADA), 47 USC. 225 (f)(2), and § 64.605(b) of the Commission's rules, 47 CFR 64.605(b). On the basis of the state applications, the Commission has determined that: the TRS program of the states meet or exceed all operational, technical, and functional minimum standards contained in section 64.604 of the Commission's rules, 47 CFR 64.604; the TRS programs of the listed states make available adequate procedures and remedies for enforcing the requirements of the state program; and the TRS programs of the listed states in no way conflict with federal law.

DATES: This certification shall remain in effect for a five year period, beginning July 26, 2003, and ending July 25, 2008, pursuant to 47 CFR 64.605(c).

ADDRESSES: Federal Communications Commission, 445 12th Street, SW., Washington, DC 20554.

FOR FURTHER INFORMATION CONTACT: Erica Myers, (202) 418–2429 (voice), (202) 418–0464 (TTY), or e-mail *Erica.Myers@fcc.gov*.

SUPPLEMENTARY INFORMATION: This is a summary of the Commission's Public Notice, DA 03–2409, CC Docket No. CC 98–67 released July 24, 2003. Copies of applications for certification are available for public inspection and copying during regular business hours at the FCC Reference Information Center, Portals II, 445 12th Street, SW., Room CY–A257, Washington, DC 20554. The applications for certification are also available on the Commission's Web site at *http://www.fcc.gov/cgb/dro/trs_by_state.html*. They may also be purchased from the Commission's duplicating contractor, Qualex International, Portals II, 44512th Street, SW., Room CY–B402, Washington, DC 20554, telephone (202) 863–2893, facsimile (202) 863–2898, or via e-mail *qualexint@aol.com*.

To request materials in accessible formats for people with disabilities (Braille, large print, electronic files, audio format), send an e-mail to *fcc504@fcc.gov* or call Consumer & Governmental Affairs Bureau, at (202) 418–0531 (voice), (202) 418–7365 9 (TTY). The *Public Notice* can also be downloaded in Text and ASCII formats at: *http://www.fcc.gov/cgb/dro.*

Synopsis

The Commission also has determined that, where applicable, the intrastate funding mechanisms of the listed states are labeled in a manner that promotes national understanding of TRS and does not offend the public, consistent with section 64.605(d) of the Commission's rules, 47 CFR 64.605 (d).

Because the Commission may adopt changes to the rules governing relay programs, including state relay programs, the certification granted herein is conditioned on a demonstration of compliance with the new rules adopted and any additional new rules that are adopted by the Commission. The Commission will provide guidance to the states on demonstrating compliance with such rule changes.

This certification, as conditioned herein, shall remain in effect for a five year period, beginning July 26, 2003, and ending July 25, 2008, pursuant to 47 CFR 64.605 (c). One year prior to the expiration of this certification, July 25, 2007, the states may apply for renewal of their TRS program certification by filing demonstration in accordance with the Commission's rules, pursuant to 47 CFR 64.605(a) and (b).

Third Group of States Approved for Certification

File No: TRS–54–02
Michigan Public Service Commission, State of Michigan
File No: TRS–28–02
Puerto Rico Telecommunications Regulatory Board, State of Puerto Rico

Federal Communications Commission.

Thomas Wyatt,

Deputy Bureau Chief, Consumer & Governmental Affairs Bureau.

[FR Doc. 03–19688 Filed 8–1–03; 8:45 am]

BILLING CODE 6712–01–P

FEDERAL MARITIME COMMISSION

[Petition P3–03]

Petition of United Parcel Service, Inc. for Exemption Pursuant to Section 16 of the Shipping Act of 1984 to Permit Negotiation, Entry and Performance of Service Contracts; Notice of Filing

Notice is hereby given that United Parcel Service, Inc. (''Petitioner'') has petitioned, pursuant to section 16 of the Shipping Act of 1984, 46 U.S.C. app. 1715, and 46 CFR 502.67, for an exemption from the Shipping Act, to permit it to negotiate, enter into and perform service contracts.

In order for the Commission to make a thorough evaluation of the Petition, interested persons are requested to submit views or arguments in reply to the Petition no later than August 22, 2003. Replies shall consist of an original and 15 copies, be directed to the Secretary, Federal Maritime Commission, 800 North Capitol Street, NW., Washington, DC 20573–0001, and be served on Petitioner's counsels, J. Michael Cavanaugh, Esq., Holland & Knight LLP, 2099 Pennsylvania Avenue, NW., Suite 100, Washington, DC 20006–6801 and Charles L. Coleman, III, Esq., Holland & Knight LLP, 50 California Street, Suite 2800, San Francisco, California 94111. It is also requested that a copy of the reply be submitted in electronic form (WordPerfect, Word or ASCII) on diskette or e-mailed to *Secretary@fmc.gov.* Copies of the petition are available at the Office of the Secretary of the Commission, 800 N. Capitol Street, NW., Room 1046. A copy may also be obtained by sending a request to *secretary@fmc.gov* or by calling (202) 523–5725. Parties participating in this proceeding may elect to receive service of the Commission's issuances in this proceeding through email in lieu of service by U.S. mail. A party opting for electronic service shall advise the Office of the Secretary in writing and provide an email address where service can be made. Such request may be directed to *secretary@fmc.gov.*

Bryant L. VanBrakle,

Secretary.

[FR Doc. 03–19653 Filed 8–1–03; 8:45 am]

BILLING CODE 6730–01–P

FEDERAL RESERVE SYSTEM

Notice of Proposals to Engage in Permissible Nonbanking Activities or to Acquire Companies that are Engaged in Permissible Nonbanking Activities

The companies listed in this notice have given notice under section 4 of the Bank Holding Company Act (12 U.S.C. 1843) (BHC Act) and Regulation Y (12 CFR Part 225) to engage *de novo*, or to acquire or control voting securities or assets of a company, including the companies listed below, that engages either directly or through a subsidiary or other company, in a nonbanking activity that is listed in § 225.28 of Regulation Y (12 CFR 225.28) or that the Board has determined by Order to be closely related to banking and permissible for bank holding companies. Unless otherwise noted, these activities will be conducted throughout the United States.

Each notice is available for inspection at the Federal Reserve Bank indicated. The notice also will be available for inspection at the offices of the Board of Governors. Interested persons may express their views in writing on the question whether the proposal complies with the standards of section 4 of the BHC Act. Additional information on all bank holding companies may be obtained from the National Information Center website at www.ffiec.gov/nic/.

Unless otherwise noted, comments regarding the applications must be received at the Reserve Bank indicated or the offices of the Board of Governors not later than August 18, 2003.

A. Federal Reserve Bank of San Francisco (Tracy Basinger, Director, Regional and Community Bank Group) 101 Market Street, San Francisco, California 94105-1579:

1. Bank of Hawaii, Honolulu, Hawaii; Bank of Hawaii Corporation, Honolulu, Hawaii; Chicago Equity Partners Corp., Chicago, Illinois; to engage *de novo* through a joint venture between Bank of Hawaii, Honolulu, and Chicago Equity Partners, Chicago, Illinois, to be known as Bankoh Investment Partners, LLC, Honolulu, Hawaii, in investment advisory activities, pursuant to section 225.28(b)(6)(i) of Regulation Y.

Board of Governors of the Federal Reserve System, July 29, 2003.

Jennifer J. Johnson,

Secretary of the Board.

[FR Doc.03–19669 Filed 8–01–03; 8:45 am]

BILLING CODE 6210–01–S

FEDERAL TRADE COMMISSION

Policy Statement on Monetary Equitable Remedies in Competition Cases

AGENCY: Federal Trade Commission (FTC).

ACTION: Notice.

SUMMARY: The Commission has issued a policy statement on the use of disgorgement as a remedy for violations of the Hart-Scott-Rodino (HSR) Act, FTC Act and Clayton Act.

DATES: The Commission approved this policy statement on July 25, 2003.

FOR FURTHER INFORMATION CONTACT: John D. Graubert, Principal Deputy General Counsel, Office of General Counsel, FTC, 600 Pennsylvania Avenue, NW., Washington, DC 20580, (202) 326–2186, *jgraubert@ftc.gov.*

SUPPLEMENTARY INFORMATION:

Policy Statement on Monetary Equitable Remedies in Competition Cases

In recent years the Commission has given considerable thought to the appropriate circumstances in which to seek, as a matter of prosecutorial discretion, monetary equitable remedies (particularly disgorgement or restitution) in competition cases brought pursuant to section 13(b) of the FTC Act.[1] In December 2001, the Commission issued a notice requesting comment on the issue,[2] and received six comments in response.[3] The agency has also reviewed relevant case law and literature, including a number of sources cited by commentors, as well as discussions in public fora and its own experience. The Commission may use all these resources to inform its decisions whether to seek monetary remedies in particular competition matters on a case by case basis. In addition, the Commission sets forth below some general observations on the use of disgorgement or restitution in competition cases.[4]

Disgorgement is an equitable monetary remedy ''designed to deprived a wrongdoer of his unjust enrichment and to deter others'' from future violations.[5] Depriving the violator of any of the benefits of illegal conduct has long been accepted as an appropriate, indeed necessary, element of antitrust remedies. *See, e.g., United States* v. *Grinnell Corp.,* 384 U.S. 563, 577 (1966); *Schine Chain Theatres, Inc.* v. *United States.,* 334 U.S. 110, 128 (1948). Restitution is also an equitable remedy, serving different but often complimentary purposes. Restitution is intended to restore the victims of a violation to the position they would have been in without the violation, often by refunding overpayments made as a result of the violation. The Commission has sought and obtained disgorgement or restitution in a number of competition cases over the last few decades,[6] most recently in the *Mylan*[7] and *Hearst*[8] matters. In exercising its prosecutorial discretion in the competition area, however, the Commission has moved cautiously and used its monetary remedial authority there sparingly. The Commission continues to believe that disgorgement and restitution can play a useful role in some competition cases, complementing more familiar remedies such as divestiture, conduct remedies, private damages, and civil or criminal penalties. The competition enforcement regime in the United States is multifaceted, and it is important and beneficial that there be a number of flexible tools, as well as a number of potential enforcers, available to address competitive problems in a particular case. Nonetheless, we do not view monetary disgorgement or restitution as routine remedies for antitrust cases. In general, we will continue to rely primarily on more familiar, prospective remedies, and seek disgorgement and restitution in exceptional cases.

As a general matter, the Commission will consider the following three factors in determining whether to seek disgorgement or restitution in a competition case. *First,* the Commission will ordinarily seek monetary relief only where the underlying violation is clear. *Second,* there must be a reasonable basis for calculating the amount of a remedial payment. *Third,* the Commission will consider the value of seeking monetary relief in light of any other remedies available in the matter, including private actions and criminal proceedings. A strong showing in one area may tip the decision whether to seek monetary remedies. For example, a particularly egregious violation may justify pursuit of these remedies even if there appears to be some likelihood of private actions. Moreover, the pendency of numerous private actions may tilt the balance the other way, even if the violation is clear.

Clear Violation

The Commission will ordinarily seek monetary disgorgement only when the violation is clear. A violation is ''clear'' for this purpose when, based on existing precedent, a reasonable party should expect that the conduct is issue would likely be found to be illegal. (''Clearness'' is therefore measured *ex ante,* as of the time the act occurs, and not *ex post* with the benefit of hindsight.) In such cases, the use of disgorgement will serve an appropriate deterrence goal. One key purpose of the disgorgement remedy is to remove the incentive to commit violations by demonstrating to the potential violator that unlawful conduct will not be profitable. This purpose can best be served when the violator can determine in advance that its conduct would probably be considered illegal. Disgorgement might arguably serve useful purposes whether or not the violation was clear—for instance, by providing an example for future violators and restoring the relevant market to its pre-violation status (thereby removing any unfair advantages obtained by the violator). Overall, however, the Commission believes that the value of deterrence is reduced when the violator has no reasonable way of knowing in advance that its conduct is placing it in jeopardy of having to pay back all the potential gains.[9]

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[1] 15 U.S.C. 53(b).

[2] 66 FR 67254 (Dec. 28, 2001); also available on the Commission's web site at *http://www.ftc.gov/os/2001/12/disgorgefrn.htm.*

[3] The following filed comments: The Antitrust Section of the American Bar Association, the American Antitrust Institute, the American Enterprise Institute for Public Policy Research, James M. Spears, Stephen A. Stack, and Kenneth G. Starling. These comments are available at *http://www.ftc.gov/os/comments/disgorgement/index.htm.*

[4] This statement sets forth some observations and intentions of the Commission regarding its exercise of discretion in determining whether to seek monetary equitable remedies in competition cases. It does not create any right or obligation, impose any element of proof, or adjust the burden of proof or production of evidence on any particular issue, as those standards have been established by the courts. This statement of policy does not apply to consumer protection cases.

[5] *SEC* v. *First City Financial Corp.,* 890 F.2d 1215, 1230 (D.C. Cir. 1989).

[6] *See FTC* v. *College of Physicians-Surgeons of Puerto Rico,* Civ. No. 97–2466 HL (D.P.R. Oct. 2, 1997) (alleged price-fixing and boycott, under FTC Act sections 5(a) and 13(b); stipulated judgment included $300,000 restitution to Puerto Rico); *FTC* v. *Mead Johnson & Co.,* No. 92–1266 (D.D.C. June 11, 1992) (alleged bid-rigging, under FTC Act sections 5(a) and 13(b); stipulated judgment included restitution in kind to USDA); *FTC* v. *American Home Products Corp.,* Civ. No. 92–1367 (D.D.C. June 11, 1992) (same); *FTC* v. *Joseph Dixon Crucible Co.,* Civ. No. C80–700 (N.D. Ohio 1983) (alleged price-fixing, under Section 5(1) for violation of earlier order; stipulated judgment included $525,000 in consumer redress, plus $75,000 civil penalty); *Commonwealth Land Title Ins. Co.,* 126 F.T.C. 680, 688 (1998) (alleged price-fixing; consent order included refund of excess charges); *Binney & Smith Inc.,* 96 F.T.C. 625 (1980) (alleged price-fixing; consent order included $1 million in consumer redress); *Milton Bradley Co.,* 96 F.T.C. 638 (1980) (same; consent order included $200,000 in consumer redress); *American Art Clay Co.,* 96 F.T.C. 809 (1980) (same; consent order included $25,000 in consumer redress); *see also FTC* v. *Abbott Laboratories,* 1992–2 Trade Cas. (CCH) ¶ 69,996 (D.D.C. 1992) (Gesell, J.), *dismissed on other grounds,* 853 F. Supp. 526 (D.D.C. 1994) (holding that FTC Act section 13(b) permitted the FTC to seek permanent injunction ordering restitution in antitrust case); FTC press release, June 5, 1989, re: A&P/Waldbaums (noting position of Commissioner Strenio that Commission should have exercised its ''authority to obtain full disgorgement of these ill-gotten gains'').

[7] *FTC* v. *Mylan Labs, Inc.,* No. 1:98CV03114 (TFH) (D.D.C. Feb 9, 2001) (alleged monopolization; stipulated judgment included $100 million restitution); *see* Mem. Opinion, 62 F. Supp. 2d 25, 36–37 (D.D.C.), *revised and reaffirmed in pertinent part,* 99 F. Supp. 2d 1, 4–5 (D.D.C. 1999).

[8] *FTC* v. *The Hearst Trust,* No. 1:01CV00734 (TPJ) (D.D.C. Nov. 9, 2001) (alleged anticompetitive acquisition and violation of pre-merger filing requirements; stipulated judgment included $19 million disgorgement).

[9] The analysis may be slightly more complicated in cases in which the Commission is seeking restitution rather than disgorgement. Restitution focuses on the victim, not the violator, and is justified by the need to restore the victim to the status quo ante, not on ex ante deterrence of unlawful conduct by a defendant. Thus, for example, when significant consumer harm will not (for one reason or another) be redressed through a private action (see discussion of our third factor, below), the Commission might therefore consider

Continued

The Commission will assess whether a violation is ''clear'' by means of an objective, not a subjective, standard, *i.e.,* a reasonableness test. ''Naked'' restraints of trade, such as price-fixing or horizontal market division, are presumptively clear cases. The list of ''clear'' cases, however, goes beyond traditional per se violations. The *Hearst* and *Mylan* cases are themselves examples of easily condemned conduct that would not necessarily be described as a per se violation: In *Hearst,* merger to monopoly aided by withholding key documents from the FTC; [10] and in *Mylan*, conspiracy to obtain monopoly power through exclusive supply agreements (unsupported by any legitimate business purpose).[11]

Conversely, in the Commission's statement accompanying the issuance of its consent agreement in *Abbott Laboratories and Geneva Pharmaceuticals, Inc.,* File No. 981–0395 (March 16, 2000), the Commission noted that the case represented the first resolution of an antitrust challenge by the government to a private agreement whereby a brand name drug company paid the first generic company that sought FDA approval not to enter the market, and to retain its 180-day period of market exclusivity under the Hatch-Waxman Act. Because the behavior occurred in a complex regulatory context, and because this was the first government antitrust enforcement action in this area, the Commission believed the public interest was satisfied with orders that regulated future conduct by the parties, without further monetary relief. The Commission warned pharmaceutical firms that they ''should now be on notice, however, that [such] arrangements * * * can raise serious antitrust issues,'' and that accordingly, ''in the future, the Commission will consider its entire range of remedies in connection with enforcement actions against such arrangements, including possibly seeking disgorgement of illegally obtained profits.'' [12]

Reasonable Basis for Calculation of Remedy

The Commission will not seek a monetary equitable remedy when there is no reasonable basis for calculating the amount of the disgorgement or restitution to be ordered. Thus, the agency does not expect to seek disgorgement unless it can suggest to a court a reasonable means of calculating the gains or benefits from a violation, nor to seek restitution unless it can offer a reasonable gauge of the amount of injury from a violation. Nontheless, a reasonable basis for calculation does not require undue precision. *See, e.g., FTC* v. *Febre,* 128 F.3d 530, 535 (7th Cir. 1997); *see also SEC* v. *Bilzerian,* 29 F.3d 689 (D.C. Cir. 1994); *SEC* v. *First City Financial Corporation, Ltd.,* 890 F.2d 1215 (D.C. Cir. 1989).

Value Added by the Commission's Monetary Remedy

The Commission will consider monetary remedies when it anticipates that other remedies are likely to fail to accomplish fully the purposes of the antitrust laws or when such a monetary remedy may provide important additional benefits. When other remedies are brought to bear and are likely to result in complete relief, a Commission action for monetary equitable relief might well be an unnecessary and unwise expenditure of limited agency resources.[13]

Thus, for example, a case may be particularly appropriate for disgorgement when private actions likely will not remove the total unjust enrichment from a violation. If statutes of limitation for, or market disincentives to, private damage actions are likely to leave a violator with some or all of the fruits of its violation, we may seek disgorgement to prevent the violator from benefitting from the violation. Similarly, when practical or legal difficulties are likely to preclude compensation for those injured by a violation who in equity should be made whole, we may seek restitution for them.[14] Such situations can arise, for example, when significant aggregate consumer injury results from relatively small individual injuries not justifying the cost of a private lawsuit, or when direct purchasers do not sue (for a variety of possible reasons) and indirect purchasers are precluded from suit under section 4 of the Clayton Act.

Disgorgement can also be particularly valuable when the advantages a violator reaps from the violation greatly outweigh the specific penalties prescribed in applicable laws, and thereby overwhelm the significant disincentive to violating the law that such penalties otherwise provide.[15] The paramount purpose of disgorgement is to make sure that wrongdoers do not profit from their wrongdoing. *E.g., SEC* v. *First City Financial Corp., supra; SEC* v. *Tome,* 833 F.2d 1086 (2d Cir. 1987),

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seeking restitution even if the conduct at issue does not otherwise meet our definition of a ''clear'' violation.

[10] Although there are some disagreement among the Commissioners in *Hearst* on whether seeking disgorgement resulted in the optimal payment from the defendants, there was general agreement that the conduct at issue was egregious. It is axiomatic that a merger of the only significant competitors in a market (absent unusual circumstances such as proof of the ''failing firm'' criteria of Section 5 of the Horizontal Merger Guidelines) violates the letter of the Clayton and Sherman Acts. *See United States* v. *Aluminum Co. of America,* 148 F.2d 416, 429 (2d Cir. 1945); Areeda, Hovenkamp & Solow, IV ANTITRUST LAW section 14.12 (2002 ed.). The case is further bolstered when, as in *Hearst,* such conduct is paired with evidence of specific intent to monopolize. *See United States* v. *Microsoft Corp,* 253 F.3d 34, 59 (D.C. Cir.), (en banc), *cert. denied,* 534 U.S. 952 (2001); Statement of Chairman Pitofsky and Commissioners Anthony and Thompson (Apr. 2001) (available at *http://www.ftc.gov/os/2001/04/hearstpitantthom.htm).*

[11] According to the Commission's complaint in *Mylan,* the parties' exclusive arrangements covered 90% of the supply of the ingredient necessary to produce one of the drugs at issue, and 100% with respect to a second drug. The Commissioners all characterized the conduct alleged as ''egregious,'' with one Commissioner observing that the facts alleged described ''a clear cut antitrust violation.'' Statement of Commissioner Thomas B. Leary, Dissenting in Part and Concurring in Part (available at *http://www.ftc.gov/os/2000/11/mylanlearystatement.htm).*

[12] *See http://www.ftc.gov/opa/2000/03/hoechst.htm.*

[13] Several commentors suggested that the mere availability of treble damage actions or other avenues of relief will ordinarily render disgorgement unnecessary, implying that ultimately such other actions will have extracted the full amount of unjust enrichment from violators and will provide adequate deterrence against future violations. On the current state of the record we cannot share this confidence. We have not been directed to empirical evidence indicating that existing remedies routinely achieve these goals, let alone evidence that antitrust defendants have been subjected to excessive, ''duplicative'' damage awards. In fact it appears that the issue has been the subject of considerable debate. *See, e.g.,* Richard Posner, ANTITRUST LAW 47 (2d ed. 2001); John Lopatka & William Page, *Who Suffered Antitrust Injury in the Microsoft Case?,* 69 Geo. Wash. L. Rev. 829 (2001); Robert Lande, *Are Antitrust ''Treble'' Damages Really Single Damages?,* 54 Ohio St. L.J. 115 (1993); Steven Salop & Lawrence White, *Economic Analysis of Private Antitrust Litigation,* 74 GEO. L.J. 1001, 1033–39 (1986); Walter Erickson, *The Profitability of Violating the Antitrust Laws: Dissolution and Treble Damages in Private Antitrust,* 5:4 Antitrust L. & Econ. Rev. 101 (1972); Alfred Parker, *Treble Damage Action—A Financial Deterrent to Antitrust Violations?,* 16 Antitrust Bull. 483 (1971); *compare* Joseph Gallo *et al., Department of Justice Antitrust Enforcement, 1955–1997: An Empirical Study,* 17 Rev. Indus. Org. 75, 125–27 (2000). The Commission will therefore need to continue to evaluate this issue on a case-by-case basis.

[14] For example, *Hearst* presented the somewhat unusual case of a consummated merger that had passed through the HSR review process. Absent FTC action, private plaintiffs would have faced the possibly discouraging prospect of not only having to prove a violation of section 7 of the Clayton Act or section 2 of the Sherman Act, but also, as a practical matter, needing to show a violation of the Hart-Scott-Rodino premerger notification rules to explain why the FTC took no action with respect to the merger.

[15] Such a discrepancy could also be addressed by the Department of Justice in a criminal action seeking, among other remedies, the significant penalties under the alternative fines provisions of the Sentencing Reform Act. 18 U.S.C. 3571(d). When DOJ has initiated a criminal prosecution, however, under existing institutional arrangements the Commission ordinarily will defer to DOJ and not bring a separate action for monetary relief.

cert. denied, 486 U.S. 1014–15 (1988); *see also FTC* v. *Gem Merchandising Corp.,* 87 F.3d 466, 470 (11th Cir. 1996).

The Commission is sensitive to the interest in avoiding duplicative recoveries by injured persons or ''excessive'' multiple payments by defendants for the same injury. Thus, although a particular illegal practice may give rise both to monetary equitable remedies and to damages under the antitrust laws, when an injured person obtains damages sufficient to erase an injury, we do not believe that equity warrants restitution to that person. We will take pains to ensure that injured persons who recover losses through private damage actions under the Clayton Act not recover doubly for the same losses via FTC-obtained restitution. Similarly, in cases involving both disgorgement and restitution, we would apply any available disgorged funds toward restitution and credit any funds paid for restitution against the amount of disgorgement.

We do not, however, consider it appropriate to offset a civil penalty assessment against disgorgement or restitution. As noted above, disgorgement is an equitable remedy whose purpose is simply to remove the unjust gain of the violator. Penalties are intended to punish the violator and reflect a different, additional calculation of the amount that will serve society's interest in optimal deterrence, retribution, and perhaps other interests. A penalty award would have no punitive effect if it were simply offset against these equitable remedies. It is no the Commission's intent, therefore, to allow its monetary relief proceedings to dilute the effectiveness of a civil penalty.

When the same conduct gives rise to two different causes of action, moreover, the imposition of remedies for each cause of action does not necessarily mean the resulting sanctions are ''excessive.'' *See e.g., California* v. *ARC America Corp.,* 490 U.S. 93 (1989); *Loeb Industries, Inc.* v. *Sumitomo Corp.,* 306 F.3d 469, 492 (7th Cir. 2002), *cert. denied,* 123 S. Ct. 2247 (2003); *In Re Lorazepam & Clorazepate Antitrust Litigation,* MDL Dkt. No. 1290 (D.D.C.) (denial of motion to dismiss, July 2, 2001) Mem. Order at 15–16. Ultimately, we believe that courts considering equitable remedies have sufficient flexibility to craft orders to avoid unjust results.[16] We have not yet encountered any such complications.

As a procedural matter, in the Commission's two recent cases in which disgorgement was approved, claims administration procedures were being developed in parallel state and private litigation. To simplify the process and avoid any appearance of duplicative payments, in each of those cases the funds recovered by the Commission were combined with other recoveries and a single claims administration process handled the administration of all the funds. In future cases, the Commission could also consider the suggestion of several commentors to set up an escrow fund, to seek appointment of a special master or claims administrator to determine the appropriate allocation of funds collected, or to seek to coordinate parallel actions.

By direction of the Commision

Donal S. Clark,

Secretary.

[FR Doc. 03–19722 Filed 8–1–03; 8:45 am]

BILLING CODE 6750–01–M

[16] Courts routinely allows ''set-offs'' and credits, for example, to avoid duplicative payments. *See, e.g., SEC* v. *First Jersey Sec., Inc.,* 101 F. 3d 1450, 1475 (2d Cir. 1996), *cert. denied,* 552 U.S. 812 (1997); *SEC* v. *Penn Cent. Co.,* 425 F. Supp. 593, 599 (E.D. Pa. 1976); *see also SEC* v. *Texas Gulf Sulphur Co.,* 446 F.2d 1301, 1307 (2d Cir.) (establishing escrow fund to prevent ''double liability''), *cert denied,* 404 U.S. 1005 (1971).

HARRY S. TRUMAN SCHOLARSHIP FOUNDATION

Notice of Intent To Extend an Information Collection

AGENCY: Harry S. Truman Scholarship Foundation.

ACTION: Notice and request for comments.

SUMMARY: In compliance with the requirements of section 3506(c)(2)(A) of the Paperwork Reduction Act of 1995 for opportunity for public comment on proposed data collection projects, the Harry S. TrumanScholarship Foundation [Foundation] will publish periodic summaries of proposed projects.

Comments are invited on (a) whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information shall have practical utility; (b) the accuracy of the agency's estimate of the burden of the proposed collection of information; (c) ways to enhance the quality, utility and clarity of the information to be collected; and (d) ways to minimize the burden of the collection of information on respondents, including through the use of automated collection techniques or the forms of information technology.

DATES: Written comments on this notice must be received by October 3, 2003 to be assured of consideration. Comments received after that date will be considered to the extent practicable.

FOR FURTHER INFORMATION CONTACT: Contact Louis H. Blair, Executive Secretary, Harry S. Truman Scholarship Foundation, 712 Jackson Place, NW., Washington, DC 20006; telephone 202–395–4831; or send e-mail to *lblair@truman.gov.* You also may obtain a copy of the data collection instrument and instructions from Mr. Blair.

SUPPLEMENTARY INFORMATION:

Title of Collection: Truman Scholar Payment Request Form.

OMB Approval Number: 3200–0005.

Expiration Date of Approval: September 30, 2003.

Type of Request: Intent to seek approval to extend an information collection for three years.

Proposed Project: The Foundation has been providing scholarships since 1977 in compliance with Public Law 93–642. This data collection instrument is used to collect essential information to enable the Truman Scholarship Foundation to determine the amount of financial support to which each Truman Scholar is eligible and then to make the payment. A total response rate of 100% was provided by the 315 Truman Scholars who received support in FY 2002.

Estimate of Burden: The Foundation estimates that, on average, 0.5 hours per Scholar applying for funds will be required to complete the Payment Request Form, for a total annual burden of 157.5 hours for all applicants.

Respondents: Individuals.

Estimated Number of Responses: 215.

Estimated Total Annual Burden on Respondents: 157.5 hours.

Dated: July 30, 2003.

Louis H. Blair,

Executive Secretary.

[FR Doc. 03–19777 Filed 8–1–03; 8:45 am]

BILLING CODE 6820–AD–U

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Centers for Disease Control and Prevention

[30Day–59–03]

Proposed Data Collections Submitted for Public Comment and Recommendations

The Centers for Disease Control and Prevention (CDC) publishes a list of information collection requests under review by the Office of Management and

Budget (OMB) in compliance with the Paperwork Reduction Act (44 U.S.C. Chapter 35). To request a copy of these requests, call the CDC Reports Clearance Officer at (404) 498–1210. Send written comments to CDC, Desk Officer, Human Resources and Housing Branch, New Executive Office Building, Room 10235, Washington, DC 20503 or by fax to (202) 395–6974. Written comments should be received within 30 days of this notice.

Proposed Project

Emergency Epidemic Investigations (0920–0008)—Extension—(Epidemiology Program Office, EPO)—One of the objectives of CDC's epidemic services is to provide for the prevention and control of epidemics and protect the population from public health crises such as man made or natural biological disasters and chemical emergencies. This is carried out, in part, by training investigators, maintaining laboratory capabilities for identifying potential problems, collecting and analyzing data, and recommending appropriate actions to protect the public's health. When state, local, or foreign health authorities request help in controlling an epidemic or solving other health problems, CDC dispatches skilled epidemiologists from the Epidemic Intelligence Service (EIS) to investigate and resolve the problem. Resolving public health problems rapidly ensures costs effective health care and enhances health promotion and disease prevention. Annually, the EIS Program coordinates 400 Epidemic Assistance Investigations (Epi-Aids) and state-based field investigations. Epidemics are prevented and controlled by mobilizing and deploying CDC staff, primarily EIS officers to respond rapidly to disease outbreaks and disaster situations. At the request of public health officials—at the state, national, or international level—CDC provides assistance by participating in epidemiologic field investigations.

The purpose of the Emergency Epidemic Investigation surveillance is to collect data on the conditions surrounding and preceding the onset of a problem. The data must be collected in a timely fashion so that information can be used to develop prevention and control techniques, to interrupt disease transmission and to help identify the cause of an outbreak. Since the events necessitating the collections of information are of an emergency nature, most data collection is done by direct interview or written questionnaire and are one-time efforts related to a specific outbreak or circumstance. If during the emergency investigation, the need for further study is recognized, a project is designed and separate OMB clearance is required. Interviews are conducted to be as unobtrusive as possible and only the minimal information necessary is collected. The Emergency Epidemic Investigations is the principal source of data on outbreaks of infectious and noninfectious diseases, injuries, nutrition, environmental health and occupational problems.

Each investigation does contribute to the general knowledge about a particular type of problem or emergency, so that data collections are designed taking into account similar situations in the past. Some questionnaires have been standardized, such as investigations of outbreaks aboard aircraft or cruise vessels.

The Emergency Epidemic Investigations provides a range of data on the characteristics of outbreaks and those affected by them. Data collected include demographic characteristics, exposure to the causative agent(s), transmission patterns and severity of the outbreak on the affected population. These data, together with trend data, may be used to monitor the effects of change in the health care system, planning of health services, improving the availability of medical services and assessing the health status of the population.

Users of the Emergency Epidemic Investigations data include, but are not limited to EIS Officers in investigating the patterns of disease or injury, investigating the level of risky behaviors, identifying the causative agent and identifying the transmission of the condition and the impact of interventions.

It is difficult to predict the number of epidemic investigations which might occur in any given year. The previous three years' experience shows an annualized burden of 3,000 hours and respondent total of 12,000. For this clearance, we are requesting 3,750 total burden hours. This is due to the increase in the number of investigations performed over the past two years.

Respondents	Number of respondents	Number of responses/respondent	Avg. burden per response (in hrs.)
Total Respondents	15,000	1	15/60

Dated: July 29, 2003.

Thomas A. Bartenfeld,

Acting Associate Director for Policy, Planning, and Evaluation, Centers for Disease Control and Prevention (CDC).

[FR Doc. 03–19685 Filed 8–1–03; 8:45 am]

BILLING CODE 4163–18–P

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Centers for Disease Control and Prevention

[30Day–55–03]

Proposed Data Collections Submitted for Public Comment and Recommendations

The Centers for Disease Control and Prevention (CDC) publishes a list of information collection requests under review by the Office of Management and Budget (OMB) in compliance with the Paperwork Reduction Act (44 U.S.C. Chapter 35). To request a copy of these requests, call the CDC Reports Clearance Officer at (404) 498–1210. Send written comments to CDC, Desk Officer, Human Resources and Housing Branch, New Executive Office Building, Room 10235, Washington, DC 20503 or by fax to (202) 395–6974. Written comments should be received within 30 days of this notice.

Proposed Project

Congenital Syphilis (CS) Case Investigation and Report Form (OMB Control No. 0920–0128)—Revision—National Center for HIV, STD, and TB Prevention (NCHSTP), Centers for Disease Control and Prevention (CDC). CDC proposes to continue data collection for congenital syphilis case investigations under the ''Congenital Syphilis Case Investigation and Report Form'' (CDC73.126 REV 11–98); this form is currently approved under OMB

No. 0920–0128. This request is for a 3-year extension of clearance. Reducing congenital syphilis is a national objective in the DHHS Report entitled Healthy People 2010 (Vol I and II). Objective 25–9 of this document states the goal: ''Reduce congenital syphilis to 1 new case per 100,000 live births''. In order to meet this national objective, an effective surveillance system for congenital syphilis must be continued to monitor current levels of disease and progress towards the year 2010 objective. This data will also be used to develop intervention strategies and to evaluate ongoing control efforts.

Respondent burden is approximately 15 minutes per reported case. The estimated annual number of cases expected to be reported using the current case definition is 500 or less. Therefore, the total number of hours for congenital syphilis reporting required will be approximately 130 hours per year.

Respondents	Number of respondents	Number of responses/respondent	Average burden/response (in hours)
State/Local Health Departments	65	8	15/60

Dated: July 29, 2003.

Thomas A. Bartenfeld,

Acting Associate Director for Policy, Planning and Evaluation, Centers for Disease Control and Prevention.

[FR Doc. 03–19686 Filed 8–1–03; 8:45 am]

BILLING CODE 4163–18–P

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Centers for Disease Control and Prevention

Disease, Disability, and Injury Prevention and Control Special Emphasis Panel (SEP): Minority Human Immunodeficiency Virus/Acquired Immunodeficiency Syndrome (HIV/AIDS) Research Initiative To Build Capacity in Black and Hispanic Communities and Among Researchers Who Conduct HIV/AIDS Epidemiologic and Prevention Research in These Communities, Program Announcement Number 03097

In accordance with section 10(a)(2) of the Federal Advisory Committee Act (Pub. L. 92–463), the Centers for Disease Control and Prevention (CDC) announces the following meeting:

Name: Disease, Disability, and Injury Prevention and Control Special Emphasis Panel (SEP): Minority Human Immunodeficiency Virus/Acquired Immunodeficiency Syndrome (HIV/AIDS) Research Initiative to Build Capacity in Black and Hispanic Communities and Among Researchers Who Conduct HIV/AIDS Epidemiologic and Prevention Research in these Communities, Program Announcement Number 03097.

Times and Dates: 8:30 a.m.–9 a.m., August 18, 2003 (Open). 9 a.m.–5 p.m., August 18, 2003 (Closed). 8:30 a.m.–5 p.m., August 19, 2003 (Closed).

Place: The Westin Hotel at Perimeter, 7 Concourse Parkway, Atlanta, GA 30328, Telephone 770.395.3900.

Status: Portions of the meeting will be closed to the public in accordance with provisions set forth in Section 552b(c) (4) and (6), Title 5 U.S.C., and the Determination of the Director, Management Analysis and Services Office, CDC, pursuant to Public Law 92–463.

Matters to be Discussed: The meeting will include the review, discussion, and evaluation of applications received in response to Program Announcement Number 03097.

Note: Due to program oversight, this **Federal Register** Notice is being published less than 15 days before the date of the meeting.

FOR FURTHER INFORMATION CONTACT: Beth Wolfe, Prevention Support Office, National Center for HIV, STD, and TB Prevention, CDC, 1600 Clifton Road, NE., MS–E07, Atlanta, GA 30333, Telephone 404.639.8531.

The Director, Management Analysis and Services Office, has been delegated the authority to sign **Federal Register** notices pertaining to announcements of meetings and other committee management activities, for both CDC and the Agency for Toxic Substances and Disease Registry.

Dated: July 30, 2003.

Alvin Hall,

Director, Management Analysis and Services Office, Centers for Disease Control and Prevention (CDC).

[FR Doc. 03–19829 Filed 7–31–03; 11:41 am]

BILLING CODE 4163–18–P

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Centers for Medicare and Medicaid Services

[Document Identifier: CMS–255, CMS–R–199]

Agency Information Collection Activities: Proposed Collection; Comment Request

AGENCY: Centers for Medicare and Medicaid Services, HHS.

In compliance with the requirement of section 3506(c)(2)(A) of the Paperwork Reduction Act of 1995, the Centers for Medicare and Medicaid Services (CMS) (formerly known as the Health Care Financing Administration (CMS)), Department of Health and Human Services, is publishing the following summary of proposed collections for public comment. Interested persons are invited to send comments regarding this burden estimate or any other aspect of this collection of information, including any of the following subjects: (1) The necessity and utility of the proposed information collection for the proper performance of the agency's functions; (2) the accuracy of the estimated burden; (3) ways to enhance the quality, utility, and clarity of the information to be collected; and (4) the use of automated collection techniques or other forms of information technology to minimize the information collection burden.

Type of Information Collection Request: Extension of a currently approved collection; *Title of Information Collection:* Municipal Health Services Cost Report Form and supporting Regulations 42 CFR 405.2470; *Form No.:* CMS–255 (OMB# 0938–0155); *Use:* The Municipal Health Services Program Cost Report (CMS 255) is used by the participating clinics to report costs for health care services rendered to Medicare beneficiaries. It is also used to gather data to properly evaluate the demonstration; *Frequency:* Annually; *Affected Public:* Not-for-profit institutions; *Number of Respondents:* 14; *Total Annual Responses:* 14; *Total Annual Hours:* 476.

2. *Type of Information Collection Request:* Extension of a currently approved collection; *Title of Information Collection:* Medicaid Report on Payables and Receivables; *Form No.:* CMS–R–199 (OMB# 0938–0697); *Use:* The Chief Financial Officers Act of 1990 requires government agencies to produce auditable financial statements. This form will collect accounting data from the States on Payables and Receivables; *Frequency:* Annually; *Affected Public:* State, Local or Tribal Government; *Number of Respondents:* 57; *Total Annual Responses:* 57; *Total Annual Hours:* 342.

To obtain copies of the supporting statement and any related forms for the proposed paperwork collections referenced above, access CMS's Web Site address at *http://cms.hhs.gov/regulations/pra/default.asp,* or e-mail your request, including your address, phone number, OMB number, and CMS document identifier, to *Paperwork@cms.hhs.gov,* or call the Reports Clearance Office on (410) 786–1326. Written comments and recommendations for the proposed information collections must be mailed within 60 days of this notice directly to the CMS Paperwork Clearance Officer designated at the following address: CMS, Office of Strategic Operations and Regulatory Affairs, Division of Regulations Development and Issuances, Attention: Dawn Willinghan, Room: C5–14–03, 7500 Security Boulevard, Baltimore, Maryland 21244–1850.

Dated: July 28, 2003.

Julie Brown,

Acting CMS Reports Clearance Officer, Division of Regulations Development and Issuances, Office of Strategic Operations and Strategic Affairs.

[FR Doc. 03–19698 Filed 8–1–03; 8:45 am]

BILLING CODE 4120–03–P

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Centers for Medicare and Medicaid Services

[Document Identifier: CMS–643, CMS–668B, CMS–10067]

Agency Information Collection Activities: Submission for OMB Review; Comment Request

AGENCY: Centers for Medicare and Medicaid Services, HHS.

In compliance with the requirement of section 3506(c)(2)(A) of the Paperwork Reduction Act of 1995, the Centers for Medicare and Medicaid Services (CMS) (formerly known as the Health Care Financing Administration (CMS)), Department of Health and Human Services, is publishing the following summary of proposed collections for public comment. Interested persons are invited to send comments regarding this burden estimate or any other aspect of this collection of information, including any of the following subjects: (1) The necessity and utility of the proposed information collection for the proper performance of the agency's functions; (2) the accuracy of the estimated burden; (3) ways to enhance the quality, utility, and clarity of the information to be collected; and (4) the use of automated collection techniques or other forms of information technology to minimize the information collection burden.

1. *Type of Information Collection Request:* Extension of a currently approved request; *Title of Information Collection:* Hospice Survey and Deficiencies Report Form and Supporting Regulations at 42 CFR part 488.26 and 4442.30; *Form No.:* CMS–643 (OMB# 0938–0379); *Use:* In order to participate in the Medicare program, a hospice must meet certain Federal health and safety conditions of participation. This form will be used by State surveyors to record data about a hospice's compliance with these conditions of participation in order to initiate the certification or recertification process; *Frequency:* On occasion; *Affected Public:* Not-for-profit institutions, Business or other for-profit; *Number of Respondents:* 2,339; *Total Annual Responses:* 475; *Total Annual Hours:* 238.

2. *Type of Information Collection Request:* Extension of a currently approved collection; *Title of Information Collection:* Post Laboratory Survey Questionnaire—Laboratory, and Supporting Regulations in 42 CFR 493.1771, 493.1773, and 493.1777; *Form No.:* CMS–668B (OMB# 0938–0653); *Use:* To provide an opportunity and a mechanism for CLIA laboratories surveyed by CMS or CMS' agent to express their satisfaction and concerns about the CLIA survey process; *Frequency:* Biennially; *Affected Public:* Business or other for-profit, Not-for-profit institutions; *Number of Respondents:* 22,500; *Total Annual Responses:* 11,250; *Total Annual Hours:* 2,813.

3. *Type of Information Collection Request:* Extension of a currently approved collection; *Title of Information Collection:* Pharmacy Plus Template for Low Income Seniors under Medicaid; *Form No.:* CMS–10067 (OMB# 0938–0889); *Use:* The template for the Pharmacy Plus program for low income seniors under Medicaid will enable states to apply, via a standard format, to provide a drug benefit to elderly recipients; use of this format will expedite the process of obtaining CMS review and approval of an application; *Frequency: Other:* 3 years after initial submission for the 1915 (c) waiver; 5 years after initial submission for the 1115 demonstration; *Affected Public:* State Government; *Number of Respondents:* 51; *Total Annual Responses:* 25; *Total Annual Hours:* 115.

To obtain copies of the supporting statement and any related forms for the proposed paperwork collections referenced above, access CMS's Web site address at *http://cms.hhs.gov/regulations/pra/default.asp,* or E-mail your request, including your address, phone number, OMB number, and CMS document identifier, to *Paperwork@hcfa.gov,* or call the Reports Clearance Office on (410) 786–1326. Written comments and recommendations for the proposed information collections must be mailed within 30 days of this notice directly to the OMB desk officer: OMB Human Resources and Housing Branch, Attention: Brenda Aguilar, New Executive Office Building, Room 10235, Washington, DC 20503.

Dated: July 28, 2003.

Julie Brown,

Acting, Paperwork Reduction Act Team Leader, CMS Reports Clearance Officer, Office of Strategic Operations and Strategic Affairs, Division of Regulations Development and Issuances.

[FR Doc. 03–19699 Filed 8–1–03; 8:45 am]

BILLING CODE 4120–03–P

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Food and Drug Administration

[Docket No. 2003P–0313]

Canned Tuna Deviating From Identity Standard; Temporary Permit for Market Testing

AGENCY: Food and Drug Administration, HHS.

ACTION: Notice.

SUMMARY: The Food and Drug Administration (FDA) is announcing that a temporary permit has been issued to Bumble Bee Seafoods, Inc., to market test a product designated as ''Bumble Bee Chunk Light Tuna 'Touch of Lemon' in water, with natural lemon flavor'' that deviates from the U.S. standard of identity for canned tuna. The purpose of the temporary permit is to allow the applicant to measure consumer acceptance of the product, identify mass production problems, and assess commercial feasibility.

DATES: This permit is effective for 15 months, beginning on the date the food is introduced or caused to be introduced into interstate commerce, but not later than Novemeber 3, 2003.

FOR FURTHER INFORMATION CONTACT: Linda McCollum, Center for Food Safety and Applied Nutrition (HFS–820), Food and Drug Administration, 5100 Paint Branch Pkwy., College Park, MD 20740, 301–436–2371.

SUPPLEMENTARY INFORMATION: In accordance with 21 CFR 130.17 concerning temporary permits to facilitate market testing of foods deviating from the requirements of the standards of identity issued under section 401 of the Federal Food, Drug, and Cosmetic Act (21 U.S.C. 341), FDA is giving notice that a temporary permit has been issued to Bumble Bee Seafoods, Inc., P.O. Box 85362, 9655 Granite Ridge Dr., suite 100, San Diego, CA 92123.

The permit covers limited interstate marketing tests of products identified as ''Bumble Bee Chunk Light Tuna 'Touch of Lemon' in water, with natural lemon flavor'' that deviate from the U.S. standard of identity for canned tuna (21 CFR 161.190) in that lemon juice and lemon oil will be used as flavoring ingredients instead of lemon oil and citric acid. Also, the product will be labeled ''in water, with natural lemon flavor'' rather than ''lemon flavored chunk light tuna.'' In all other respects, the test product will conform to the standard for canned tuna. The purpose of this permit is to test the product throughout the United States.

This permit provides for the temporary marketing of approximately 20,000 tons (20,321,200 kilograms) of product packaged in 1.9 million cases. The test product will be manufactured by Bumble Bee Seafoods, Inc., 13100 Arctic Circle, Santa Fe Springs, CA 90670; and at Bumble Bee International, Inc., Malecon Industrial Zone, Jose Gonzalez Clemente Ave., Rd. 341 Km 4.5, Mayaguez, PR 00680. The product will be distributed throughout the United States.

The information panel of the labels will bear nutrition labeling in accordance with 21 CFR 101.9. Each of the ingredients used in the food must be declared on the labels as required by the applicable sections of 21 CFR part 101. This permit is effective for 15 months, beginning on the date the food is introduced or caused to be introduced into interstate commerce, but not later than November 3, 2003.

Dated: July 21, 2003.

Christine Taylor,

Director, Office of Nutritional Products, Labeling and Dietary Supplements, Center for Food Safety and Applied Nutrition.

[FR Doc. 03–19658 Filed 8–1–03; 8:45 am]

BILLING CODE 4160–01–S

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Food and Drug Administration

Peripheral and Central Nervous System Drugs Advisory Committee; Notice of Meeting

AGENCY: Food and Drug Administration, HHS.

ACTION: Notice.

This notice announces a forthcoming meeting of a public advisory committee of the Food and Drug Administration (FDA). The meeting will be open to the public.

Name of Committee: Peripheral and Central Nervous System Drugs Advisory Committee.

General Function of the Committee: To provide advice and recommendations to the agency on FDA's regulatory issues.

Date and Time: The meeting will be held on September 24 and 25, 2003, from 8 a.m. to 5 p.m.

Location: Holiday Inn, Versailles Ballrooms, 8120 Wisconsin Ave., Bethesda MD, 301–652–2000.

Contact Person: Anuja Patel, Center for Drug Evaluation and Research (HFD–21), Food and Drug Administration, 5600 Fishers Lane (for express delivery, 5630 Fishers Lane, rm. 1093) Rockville, MD 20857, 301–827–7001, FAX: 301–827–6776, or e-mail: *patelA@cder.fda.gov*, or FDA Advisory Committee Information Line, 1–800–741–8138 (301–443–0572 in the Washington, DC area), code 12543. Please call the Information Line for up-to-date information on this meeting.

Agenda: On September 24, 2003, the committee will discuss new drug application (NDA) 21–487, memantine hydrochloride, Forest Laboratories, Inc., indicated for the treatment of moderate to severe dementia of the Alzheimer's type. On September 25, 2003, the committee will discuss NDA 20–717, Provigil (modafinil) Tablets, Cephalon, Inc., indicated for use to improve wakefulness in patients with excessive sleepiness associated with disorders of sleep and wakefulness.

Procedure: Interested persons may present data, information, or views, orally or in writing, on issues pending before the committee. Written submissions may be made to the contact person by September 15, 2003. Oral presentations from the public will be scheduled between approximately 1 p.m. and 2 p.m. on both days. Time allotted for each presentation may be limited. Those desiring to make formal oral presentations should notify the contact person before September 15, 2003, and submit a brief statement of the general nature of the evidence or arguments they wish to present, the names and addresses of proposed participants, and an indication of the approximate time requested to make their presentation.

Persons attending FDA's advisory committee meetings are advised that the agency is not responsible for providing access to electrical outlets.

FDA welcomes the attendance of the public at its advisory committee meetings and will make every effort to accommodate persons with physical disabilities or special needs. If you require special accommodations due to a disability, please contact Angie Whitacre at 301–827–7001 at least 7 days in advance of the meeting.

Notice of this meeting is given under the Federal Advisory Committee Act (5 U.S.C. app. 2).

Dated: July 25, 2003.

Peter J. Pitts,

Associate Commissioner for External Relations.

[FR Doc. 03–19657 Filed 8–1–03; 8:45 am]

BILLING CODE 4160–01–S

DEPARTMENT OF HEALTH AND HUMAN SERVICES

National Institutes of Health

National Cancer Institute; Notice of Closed Meeting

Pursuant to section 10(d) of the Federal Advisory Committee Act, as amended (5 U.S.C. Appendix 2), notice is hereby given of the following meeting.

The meeting will be closed to the public in accordance with the provisions set forth in sections 552b(c)(4) and 552b(c)(6), Title 5 U.S.C., as amended. The grant applications and the discussions could disclose confidential trade secrets or commercial property such as patentable material, and personal information concerning individuals associated with the grant applications, the disclosure of which would constitute a clearly unwarranted invasion of personal privacy.

Name of Committee: National Cancer Institute Initial Review Group, Subcommittee G—Education

Date: October 21–23, 2003.

Time: 8 a.m. to 5 p.m.

Agenda: To review and evaluate grant applications.

Place: Holiday Inn Georgetown, 2101 Wisconsin Avenue, NW., Washington, DC 20007.

Contact Person: Ilda M. McKenna, PhD, Scientific Review Administrator, Research Training Review Branch, Division of Extramural Activities, National Cancer Institute, 6116 Executive Boulevard Room 8111, Bethesda, MD 20892, 301–496–7841, *mckennai@mail.nih.gov.*

(Catalogue of Federal Domestic Assistance Program Nos. 93.392, Cancer Construction; 93.393, Cancer Cause and Prevention Research; 93.394, Cancer Detection and Diagnosis Research; 93.395, Cancer Treatment Research; 93.396, Cancer Biology Research; 93.397, Cancer Centers Support; 93.398, Cancer Research Manpower; 93.399, Cancer Control, National Institutes of Health, HHS)

Dated: July 29, 2003.

LaVerne Y. Stringfield,

Director, Office of Federal Advisory Committee Policy.

[FR Doc. 03–19767 Filed 8–1–03; 8:45 am]

BILLING CODE 4140–01–M

DEPARTMENT OF HEALTH AND HUMAN SERVICES

National Institutes of Health

National Center for Complementary and Alternative Medicine; Notice of Closed Meeting

Pursuant to section 10(d) of the Federal Advisory Committee Act, as amended (5 U.S.C. Appendix 2), notice is hereby given of the following meeting.

The meeting will be closed to the public in accordance with the provisions set forth in sections 552b(c)(4) and 552b(c)(6), Title 5 U.S.C., as amended. The grant applications and the discussions could disclose confidential trade secrets or commercial property such as patentable material, and personal information concerning individuals associated with the grant applications, the disclosure of which would constitute a clearly unwarranted invasion of personal privacy.

Name of Committee: National Center for Complementary and Alternative Medicine Special Emphasis Panel, Cranberry.

Date: September 11–12, 2003.

Time: 8 a.m. to 5 p.m.

Agenda: To review and evaluate grant applications.

Place: Bethesda Marriott, 5151 Pooks Hill Road, Bethesda, MD 20814.

Contact Person: Carol Pontzer, PhD, Scientific Review Administrator, National Center for Complementary and Alternative Medicine, 6707 Democracy Blvd., Bethesda, MD 20892.

Dated: July 29, 2003.

LaVerne Y. Stringfield,

Director, Office of Federal Advisory Committee Policy.

[FR Doc. 03–19771 Filed 8–1–03; 8:45 am]

BILLING CODE 4140–01–M

DEPARTMENT OF HEALTH AND HUMAN SERVICES

National Institutes of Health

National Center for Research Resources; Notice of Meeting

Pursuant to section 10(d) of the Federal Advisory Committee Act, as amended (5 U.S.C. Appendix 2), notice is hereby given of a meeting of the National Advisory Research Resources Council.

The meeting will be open to the public as indicated below, with attendance limited to space available. Individuals who plan to attend and need special assistance, such as sign language interpretation or other reasonable accommodations, should notify the Contact Person listed below in advance of the meeting.

The meeting will be closed to the public in accordance with the provisions set forth in sections 552b(c)(4) and 552b(c)(6), Title 5 U.S.C., as amended. The grant applications and/or contract proposals and the discussions could disclose confidential trade secrets or commercial property such as patentable material, and personal information concerning individuals associated with the grant applications and/or contract proposals, the disclosure of which would constitute a clearly unwarranted invasion of personal privacy.

Name of Committee: National Advisory Research Resources Council.

Date: September 10–11, 2003.

Open: September 10, 2003, 8:30 a.m. to 6 p.m.

Agenda: Updating NCRR's Strategic Plans.

Place: Crystal Gateway Marriott, 1700 Jefferson Davis Highway, Arlington, VA 22202.

Open: September 11, 2003, 8:30 a.m. to 12:30 p.m.

Agenda: Updating NCRR's Strategic Plans.

Place: Crystal Gateway Marriott, 1700 Jefferson Davis Highway, Arlington, VA 22202.

Closed: September 11, 2003, 12:30 p.m. to Adjournment.

Agenda: To review and evaluate grant applications and/or proposals.

Place: Crystal Gateway Marriott, 1700 Jefferson Davis Highway, Arlington, VA 22202.

Contact Person: Louise E. Ramm, Phd, Deputy Director, National Center for Research Resources, National Institutes of Health, Building 31, Room 3B11, Bethesda, MD 20892, 301–496–6023.

Information is also available on the Institute's/Center's home page: *www.ncrr.nih.gov/newspub/minutes.htm,* where an agenda and any additional information for the meeting will be posted when available.

(Catalogue of Federal Domestic Assistance Program Nos. 93.306, Comparative Medicine; 93.333, Clinical Research; 93.371, Biomedical Technology; 93.389, Research Infrastructure, 93.306, 93.333, National Institutes of Health, HHS)

Dated: July 29, 2003.

LaVerne Y. Stringfield,

Director, Office of Federal Advisory Committee Policy.

[FR Doc. 03–19772 Filed 8–1–03; 8:45 am]

BILLING CODE 4140–01–M

DEPARTMENT OF HEALTH AND HUMAN SERVICES

National Institutes of Health

National Center for Research Resources; Notice of Closed Meeting

Pursuant to section 10(d) of the Federal Advisory Committee Act, as amended (5 U.S.C. Appendix 2), notice is hereby given of the following meeting.

The meeting will be closed to the public in accordance with the provisions set forth in sections 552b(c)(4) and 552b(c)(6), Title 5 U.S.C., as amended. The grant applications and the discussions could disclose confidential trade secrets or commercial property such as patentable material, and personal information concerning individuals associated with the grant applications, the disclosure of which would constitute a clearly unwarranted invasion of personal privacy.

Name of Committee: National Center for Research Resources Special Emphasis Panel Research Infrastructure.

Date: August 6, 2003.

Time: 3 p.m. to Adjournment.

Agenda: To review and evaluate grant applications.

Place: One Democracy Plaza, Office of Review, 6701 Democracy Blvd., Bethesda, MD 20892. (Telephone Conference Call).

Contact Person: William C. Angus, Ph.D., Health Scientist Administrator, Division of Research Infrastructure, National Center for Research Resources, National Institutes of Health, 6701 Democracy Blvd., MSC 4874, Room 926, Bethesda, MD 20892–4874, 301–451–4217, *angusw@mail.nih.gov.*

This notice is being published less than 15 days prior to the meeting due to the timing limitations imposed by the review and funding cycle.

(Catalogue of Federal Domestic Assistance Program Nos. 93.306, Comparative Medicine, 93.333, Clinical Research; 93.371, Biomedical Technology; 93.389, Research Infrastructure, 93.306, 93.333, National Institutes of Health, HHS)

Dated: July 29, 2003.

LaVerne Y. Stringfield,

Director, Office of Federal Advisory Committee Policy.

[FR Doc. 03–19773 Filed 8–1–03; 8:45 am]

BILLING CODE 4140–01–M

DEPARTMENT OF HEALTH AND HUMAN SERVICES

National Institutes of Health

National Center for Research Resources; Notice of Closed Meetings

Pursuant to section 10(d) of the Federal Advisory Committee Act, as amended (5 U.S.C. Appendix 2), notice is hereby given of the following meetings.

The meetings will be closed to the public in accordance with the provisions set forth in sections 552b(c)(4) and 552b(c)(6), Title 5 U.S.C., as amended. The grant applications and the discussions could disclose confidential trade secrets or commercial property such as patentable material, and personal information concerning individuals associated with the grant applications, the disclosure of which would constitute a clearly unwarranted invasion of personal privacy.

Name of Committee: National Center for Research Resources Special Emphasis Panel Comparative Medicine.

Date: September 3–4, 2003.

Time: September 3, 2003, 8 a.m. to Adjournment.

Agenda: To review and evaluate grant applications.

Place: Hillsboro Courtyard by Marriott, 3050 Stucki Place, Hillsboro, OR 97124.

Contact Person: Carol Lambert, PhD, Scientific Review Administrator, Office of Review, National Center for Research Resources, National Institute of Health, 6701 Democracy Boulevard, 1 Democracy Plaza, Room 1076, Bethesda, MD 20892–4874, (301) 435–0814, *lambert@mail.nih.gov.*

Name of Committee: Scientific and Technical Review Board on Biomedical and Behavioral Research Facilities.

Date: October 6, 2003–8, 2004.

Open: October 6, 2003, 8 a.m. to 9 a.m.

Agenda: To discuss program planning and other issues.

Place: Double Tree Rockville, 1750 Rockville Pike, Rockville, MD 20852.

Closed: October 6, 2003, 9 a.m. to Adjournment.

Agenda: To review and evaluate grant applications.

Place: Double Tree Rockville, 1750 Rockville Pike, Rockville, MD 20852.

Contact Person: D.G. Patel, PhD, Scientific Review Administrator, National Institutes of Health, National Center For Research Resources, Office of Review, 6701 Democracy, Room 1070, MSC–4874, Bethesda, MD 20892, 301–435–0824, *pateldg@mail.nih.gov.*

Name of Committee: National Center for Research Resources Initial Review Group, Clinical Research Review Committee.

Date: October 8–9, 2003.

Open: October 8, 2003, 8 a.m. to 8:30 a.m.

Agenda: To discuss program planning and other issues.

Place: Holiday Inn Select Bethesda, 8120 Wisconsin Ave., Bethesda, MD 20814.

Closed: October 8, 2003, 8:30 a.m. to Adjournment.

Agenda: To review and evaluate grant applications.

Place: Holiday Inn Select Bethesda, 8120 Wisconsin Ave., Bethesda, MD 20814.

Contact Person: Sheryl K. Brining, PhD, Acting Director, Office of Review, National Center for Research Resources, National Institutes of Health, 6701 Democracy Boulevard, 1 Democracy Plaza, Room 1074, Bethesda, MD 20892–4874, 301–435–0809, *sb44k@nih.gov.*

Name of Committee: National Center for Research Resources Special Emphasis Panel Biomedical Research Technology.

Date: October 15–16, 2003.

Time: October 15, 2003, 8 a.m. to Adjournment.

Agenda: To review and evaluate grant applications.

Place: Bethesda Marriott Suites, 6711 Democracy Boulevard, Bethesda, MD 20817.

Contact Person: Bo Hong, PhD, Scientific Review Administrator, Office of Review, National Center for Research Resources, National Institutes of Health, One Democracy Plaza, 6701 Democracy Blvd., Room 1078, Bethesda, MD 20892–7965, (301) 435–0813, *hongb@mail.nih.gov.*

(Catalogue of Federal Domestic Assistance Program Nos. 93.306, Comparative Medicine; 93.333, Clinical Research; 93.371, Biomedical Technology; 93.389, Research Infrastructure, 93.306, 93.333, National Institutes of Health, HHS)

Dated: July 22, 2003.

LaVerne Y. Stringfield,

Director, Office of Federal Advisory Committee Policy.

[FR Doc. 03–19774 Filed 8–1–03; 8:45 am]

BILLING CODE 4140–01–M

DEPARTMENT OF HEALTH AND HUMAN SERVICES

National Institutes of Health

National Institute of Diabetes and Digestive and Kidney Diseases; Notice of Closed Meeting

Pursuant to section 10(d) of the Federal Advisory Committee Act, as amended (5 U.S.C. Appendix 2), notice is hereby given of the following meeting.

The meeting will be closed to the public in accordance with the provisions set forth in sections 552b(c)(4) and 552b(c)(6), Title 5 U.S.C., as amended. The grant applications and the discussions could disclose confidential trade secrets or commercial property such as patentable material, and personal information concerning individuals associated with the grant applications, the disclosure of which would constitute a clearly unwarranted invasion of personal privacy.

Name of Committee: National Institute of Diabetes and Digestive and Kidney Diseases Special Emphasis Panel, Career Enhancement Award for Stem Cell Research.

Date: August 27, 2003.

Time: 2 p.m. to 4 p.m.

Agenda: To review and evaluate grant applications.

Place: National Institutes of Health, Two Democracy Plaza, 6707 Democracy Boulevard, Bethesda, MD 20892, (Telephone Conference Call).

Contact Person: John F. Connaughton, PhD, Scientific Review Administrator, Review Branch, DEA, NIDDK, National Institutes of Health, Room 757, 6707 Democracy Boulevard, Bethesda, MD 20892, (301) 594–7797, *connaughtonj@extra.niddk.nih.gov.*

(Catalogue of Federal Domestic Assistance Program Nos. 93.847, Diabetes, Endocrinology and Metabolic Research; 93.848, Digestive Diseases and Nutrition Research; 93.849, Kidney Diseases, Urology and Hematology Research, National Institutes of Health, HHS)

Dated: July 25, 2003.

LaVerne Y. Stringfield,

Director, Office of Federal Advisory Committee Policy.

[FR Doc. 03–19760 Filed 8–1–03; 8:45 am]

BILLING CODE 4140–01–M

DEPARTMENT OF HEALTH AND HUMAN SERVICES

National Institutes of Health

National Institute on Drug Abuse; Notice of Closed Meeting

Pursuant to section 10(d) of the Federal Advisory Committee Act, as amended (5 U.S.C. Appendix 2), notice is hereby given of the following meeting.

The meeting will be closed to the public in accordance with the provisions set forth in sections 552b(c)(4) and 552b(c)(6), Title 5 U.S.C., as amended. The contract proposals and the discussions could disclose confidential trade secrets or commercial property such as patentable material, and personal information concerning individuals associated with the contract proposals, the disclosure of which would constitute a clearly unwarranted invasion of personal privacy.

Name of Committee: National Institute on Drug Abuse Special Emphasis Panel ''Quantitation of Drugs of Abuse by GC/MS''.

Date: August 7, 2003.

Time: 9 a.m. to 5 p.m.

Agenda: To review and evaluate contract proposals.

Place: Holiday Inn Select Bethesda, 8120 Wisconsin Ave., Bethesda, MD 20814.

Contact Person: Eric Zatman, Contract Review Specialist, Office of Extramural Affairs, National Institute on Drug Abuse, National Institutes of Health, DHHS, 6001 Executive Boulevard, Room 3158, MSC 9547, Bethesda, MD 20892–9547, (301) 435–1438.

This notice is being published less than 15 days prior to the meeting due to the timing limitations imposed by the review and funding cycle.

(Catalogue of Federal Domestic Assistance Program Nos. 93.277, Drug Abuse Scientist Development Award for Clinicians, Scientist Development Awards, and Research Scientist Awards; 93.278, Drug Abuse National Research Service Awards for Research Training; 93.279, Drug Abuse Research Programs, National Institutes of Health, HHS)

Dated: July 25, 2003.

LaVerne Y. Stringfield,

Director, Office of Federal Advisory Committee Policy.

[FR Doc. 03–19761 Filed 8–1–03; 8:45 am]

BILLING CODE 4140–01–M

DEPARTMENT OF HEALTH AND HUMAN SERVICES

National Institutes of Health

National Institute on Alcohol Abuse and Alcoholism; Notice of Closed Meetings

Pursuant to section 10(d) of the Federal Advisory Committee Act, as amended (5 U.S.C. Appendix 2), notice is hereby given of the following meetings.

The meetings will be closed to the public in accordance with the provisions set forth in sections 552b(c)(4) and 552b(c)(6), Title 5 U.S.C., as amended. The grant applications and the discussions could disclose confidential trade secrets or commercial property such as patentable material, and personal information concerning individuals associated with the grant applications, the disclosure of which would constitute a clearly unwarranted invasion of personal privacy.

Name of Committee: National Institute on Alcohol Abuse and Alcoholism Special Emphasis Panel, Review of K08 and R21 Application.

Date: July 28, 2003.

Time: 10 a.m. to 11:30 a.m.

Agenda: To review and evaluate grant applications.

Place: National Institutes of Health, Wilco Building, 6000 Executive Boulevard, Suite 409, Bethesda, MD 20892 (Telephone Conference Call).

Contact Person: Sean N. O'Rourke, Scientific Review Administrator, Extramural Project Review Branch, National Institute on Alcohol Abuse and Alcoholism, National Institutes of Health, Suite 409, 6000 Executive Boulevard, Bethesda, MD 20892–7003, 301–443–2861.

This notice is being published less than 15 days prior to the meeting due to the timing limitations imposed by the review and funding cycle.

Name of Committee: National Institute on Alcohol Abuse and Alcoholism Special Emphasis Panel, AA–1 Conflict Special Emphasis Panel.

Date: August 7, 2003.

Time: 1 p.m. to 2 p.m.

Agenda: To review and evaluate grant applications.

Place: National Institutes of Health, Wilco Building, 6000 Executive Boulevard, Suite 409, Bethesda, MD 20892 (Telephone Conference Call).

Contact Person: Sathasiva B. Kandasamy, PhD, Scientific Review Administrator, Extramural Project Review Branch, Office of Scientific Affairs, National Institute on Alcohol Abuse and Alcoholism, 6000 Executive Blvd, Suite 409, Bethesda, MD 20892–7003 (301) 443–2926 *skandasa@mail.niyh.gov.*

This notice is being published less than 15 days prior to the meeting due to the timing limitations imposed by the review and funding cycle.

Name of Committee: National Institute on Alcohol Abuse and Alcoholism Special Emphasis Panel.

Date: August 29, 2003.

Time: 1 p.m. to 3 p.m.

Agenda: To review and evaluate grant applications.

Place: National Institutes of Health, Wilco Building, 6000 Executive Boulevard, Bethesda, MD 20892 (Telephone Conference Call).

Contact Person: Eugene G. Hayunga, PhD, Chief, Extramural Project Review Branch, OSA, National Institute on Alcohol Abuse and Alcoholism, National Institutes of Health, Wilco Building, Suite 409, 6000 Executive Boulevard, MSC 7003, Bethesda, MD 20892–7003, 301–443–2860; *ehayunga@mail.nih.gov.*

(Catalogue of Federal Domestic Assistance Program Nos. 93.271, Alcohol Research Career Development Awards for Scientists and Clinicians, 93.272, Alcohol National Research Service Awards for Research Training, 93.273, Alcohol Research Programs; 93.891, Alcohol Research Center Grants, National Institutes of Health, HHS)

Dated: July 25, 2003.

LaVerne Y. Stringfield,

Director, Office of Federal Advisory Committee Policy.

[FR Doc. 03–19762 Filed 8–1–03; 8:45 am]

BILLING CODE 4140–01–M

DEPARTMENT OF HEALTH AND HUMAN SERVICES

National Institutes of Health

National Institute of Neurological Disorders and Stroke; Notice of Closed Meeting

Pursuant to section 10(d) of the Federal Advisory Committee Act, as amended (5 U.S.C. Appendix 2), notice is hereby given of the following meeting.

The meeting will be closed to the public in accordance with the provisions set forth in sections 552b(c)(4) and 552b(c)(6), Title 5 U.S.C., as amended. The grant applications and the discussions could disclose confidential trade secrets or commercial property such as patentable material, and personal information concerning individuals associated with the grant applications, the disclosure of which would constitute a clearly unwarranted invasion of personal privacy.

Name of Committee: National Institute of Neurological Disorders and Stroke Special Emphasis Panel Clinical Trial R01 Application.

Date: August 23, 2003.

Time: 2 p.m. to 3 p.m.

Agenda: To review and evaluate grant applications.

Place: National Institutes of Health, Neuroscience Center, 6001 Executive

Boulevard, Rockville, MD 20852 (Telephone Conference Call).

Contact Person: Richard D. Crosland, PhD, Scientific Review Administrator, Scientific Review Branch, Division of Extramural Research, NINDS/NIH/DHHS, Neuroscience Center, 6001 Executive Blvd, Suite 3208, MSC 9529, Bethesda, MD 20892–9529, 301–594–0635.

(Catalogue of Federal Domestic Assistance Program Nos. 93.853, Clinical Research Related to Neurological Disorders; 93.854, Biological Basis Research in the Neurosciences, National Institutes of Health, HHS)

Dated: July 29, 2003.

LaVerne Y. Stringfield,

Director, Office of Federal Advisory Committee Policy.

[FR Doc. 03–19764 Filed 8–1–03; 8:45 am]

BILLING CODE 4140–01–M

DEPARTMENT OF HEALTH AND HUMAN SERVICES

National Institutes of Health

National Institute of Nursing Research; Amended Notice of Meeting

Notice is hereby given of a change in the meeting of the National Institute of Nursing Research Special Emphasis Panel, May 14, 2003, 10 a.m. to May 14, 2003, 12 p.m. National Institute of Nursing Research, 6701 Democracy Plaza, Bethesda, MD 20817 which was published in the **Federal Register** on May 15, 2003, FR 68, Pg 26324.

The meeting will be held on July 24, 2003 at 1 p.m. to 2 p.m. The meeting is closed to the public.

Dated: July 29, 2003.

LaVerne Y. Stringfield,

Director, Office of Federal Advisory Committee Policy.

[FR Doc. 03–19766 Filed 8–1–03; 8:45 am]

BILLING CODE 4140–01–M

DEPARTMENT OF HEALTH AND HUMAN SERVICES

National Institutes of Health

National Institute of Mental Health; Notice of Closed Meeting

Pursuant to section 10(d) of the Federal Advisory Committee Act, as amended (5 U.S.C. Appendix 2), notice is hereby given of the following meeting.

The meeting will be closed to the public in accordance with the provisions set forth in sections 552b(c)(4) and 552b(c)(6), Title 5 U.S.C., as amended. The grant applications and the discussions could disclose confidential trade secrets or commercial property such as patentable material, and personal information concerning individuals associated with the grant applications, the disclosure of which would constitute a clearly unwarranted invasion of personal privacy.

Name of Committee: National institute of Mental Health Special Emphasis Panel, Ancillary Studies to NIMH Multi-Site Clinical Trials.

Date: August 4, 2003.

Time: 1 p.m. to 2 p.m.

Agenda: To review and evaluate grant applications.

Place: National Institutes of Health, Neuroscience Center, 6001 Executive Boulevard, Rockville, MD 20852 (Telephone Conference Call).

Contact Person: Henry J. Haigler, PhD, Scientific Review Administrator, Division of Extramural Activities, National Institute of Mental Health, NIH, Neuroscience Center, 6001 Executive Blvd., Rm. 6150, MSC 9608, Bethesda, MD 20892–9608, 301/443–7216, *hhaigler@mail.nih.gov.*

This notice is being published less than 15 days prior to the meeting due to the timing limitations imposed by the review and funding cycle.

(Catalogue of Federal Domestic Assistance Program Nos. 93.242, Mental Health Research Grants; 93.281, Scientist Development Award, Scientist Development Award for Clinicians, and Research Scientist Award; 93.282, Mental Health National Research Service Awards for Research Training, National Institutes of Health, HHS)

Dated: July 29, 2003.

LaVerne Y. Stringfield,

Director, Office of Federal Advisory Committee Policy.

[FR Doc. 03–19768 Filed 8–1–03; 8:45 am]

BILLING CODE 4140–01–M

DEPARTMENT OF HEALTH AND HUMAN SERVICES

National Institutes of Health

National Institute of Allergy and Infectious Diseases; Notice of Closed Meeting

Pursuant to section 10(d) of the Federal Advisory Committee Act, as amended (5 U.S.C. Appendix 2), notice is hereby given of the following meeting.

The meeting will be closed to the public in accordance with the provisions set forth in sections 552b(c)(4) and 552b(c)(6), Title 5 U.S.C., as amended. The grant applications and the discussions could disclose confidential trade secrets or commercial property such as patentable material, and personal information concerning individuals associated with the grant applications, the disclosure of which would constitute a clearly unwarranted invasion of personal privacy.

Name of Committee: National Institute of Allergy and Infectious Diseases Special Emphasis Panel, ''Research Program Project: Biodefense and Emerging Infectious Diseases''.

Date: September 4, 2003.

Time: 2:30 p.m. to 5:30 p.m.

Agenda: To review and evaluate grant applications.

Place: National Institutes of Health, Rockledge 6700, 6700B Rockledge Drive, Bethesda, MD 20817, (Telephone Conference Call).

Contact Person: Gregory P. Jarosik, PhD, Scientific Review Administrator, Scientific Review Program, Division of Extramural Activities, NIAID, 6700B Rockledge Drive, MSC–7616, Bethesda, MD 20892, 301–496–2550, *gjarosik@niaid.nih.gov.*

(Catalogue of Federal Domestic Assistance Program Nos. 93.855, Allergy, Immunology, and Transplantation Research; 93.856, Microbiology and Infectious Diseases Research, National Institutes of Health, HHS)

Dated: July 29, 2003.

LaVerne Y. Stringfield,

Director, Office of Federal Advisory Committee Policy.

[FR Doc. 03–19769 Filed 8–1–03; 8:45 am]

BILLING CODE 4140–01–M

DEPARTMENT OF HEALTH AND HUMAN SERVICES

National Institutes of Health

National Institute of Allergy and Infectious Diseases; Notice of Closed Meeting

Pursuant to section 10(d) of the Federal Advisory Committee Act, as amended (5 U.S.C. Appendix 2), notice is hereby given of the following meeting.

The meeting will be closed to the public in accordance with the provisions set forth in sections 552b(c)(4) and 552b(c)(6), Title 5 U.S.C., as amended. The grant applications and the discussions could disclose confidential trade secrets or commercial property such as patentable material, and personal information concerning individuals associated with the grant applications, the disclosure of which would constitute a clearly unwarranted invasion of personal privacy.

Name of Committee: National Institute of Allergy and Infectious Diseases Special Emphasis Panel, Unsolicited Program Project Application.

Date: August 26, 2003.

Time: 11 a.m. to 3 p.m.

Agenda: To review and evaluate grant applications.

Place: National Institutes of Health/NIAID, 6700B Rockledge Drive, Bethesda, MD 20892, (Telephone Conference Call).

Contact Person: Priti Mehrotra, PhD, Scientific Review Administrator, Division of

Extramural Activities, National Institute of Allergy and Infectious Diseases, National Institutes of Health, 6700–B Rockledge Drive, Room 2100, Bethesda, MD 20892–7616, 301–435–9369, *pm158b@nih.gov.*

(Catalogue of Federal Domestic Assistance Program Nos. 93.855, Allergy, Immunology, and Transplantation Research; 93.856, Microbiology and Infectious Diseases Research, National Institutes of Health, HHS)

Dated: July 29, 2003.

LaVerne Y. Stringfield,

Director, Office of Federal Advisory Committee Policy.

[FR Doc. 03–19770 Filed 8–1–03; 8:45 am]

BILLING CODE 4140–01–M

DEPARTMENT OF HEALTH AND HUMAN SERVICES

National Institutes of Health

National Library of Medicine; Notice of Meetings

Pursuant to section 10(d) of the Federal Advisory Committee Act, as amended (5 U.S.C. Appendix 2), notice is hereby given of meetings of the Board of Regents of the National Library of Medicine.

The meetings will be open to the public as indicated below, with attendance limited to space available. Individuals who plan to attend and need special assistance, such as sign language interpretation or other reasonable accommodations, should notify the Contact Person listed below in advance of the meeting.

The meetings will be closed to the public in accordance with the provisions set forth in sections 552b(c)(4) and 552b(c)(6), Title 5 U.S.C., as amended. The grant applications and the discussions could disclose confidential trade secrets or commercial property such as patentable material, and personal information concerning individuals associated with the grant applications, the disclosure of which would constitute a clearly unwarranted invasion of personal privacy.

Name of Committee: Board of Regents of the National Library of Medicine, Extramural Programs Subcommittee.

Date: September 8, 2003.

Time: 4 p.m. to 6 p.m.

Agenda: To review and evaluate grant applications.

Place: National Institutes of Health, Building 38A, HPCC B1N30, 8600 Rockville Pike, Bethesda, MD 20892.

Contact Person: Donald A.B. Lindberg, MD, Director, National Library of Medicine, National Institutes of Health, PHS, DHHS, Bldg. 38, Room 2E17B, Bethesda, MD 20894.

Name of Committee: Board of Regents of the National Library of Medicine, Subcommittee on Outreach and Public Information.

Date: September 9, 2003.

Open: 7:30 a.m. to 8:45 a.m.

Agenda: Outreach Activities for the National Library of Medicine.

Place: National Institutes of Health, Building 38, Conference Room B, 8600 Rockville Pike, Bethesda, MD 20892.

Contact Person: Donald A.B. Lindberg, MD, Director, National Library of Medicine, National Institutes of Health, PHS, DHHS, Bldg. 38, Room 2E17B, Bethesda, MD 20894.

Name of Committee: Board of Regents of the National Library of Medicine.

Date: September 9–10, 2003.

Open: September 9, 2003, 9 a.m. to 4:30 p.m.

Agenda: Administrative Reports and Program Discussion.

Place: National Institutes of Health, Building 38, Board Room, 2E17, 8600 Rockville Pike, Bethesda, MD 20894.

Closed: September 9, 2003, 4:30 p.m. to 5 p.m.

Agenda: To review and evaluate grant applications.

Place: National Institutes of Health, Building 38, Board Room, 2E17, 8600 Rockville Pike, Bethesda, MD 20894.

Open: September 10, 2003, 9 a.m. to 12 p.m.

Agenda: Administrative Reports and Program Discussion.

Place: National Institutes of Health, Building 38, Board Room, 2E17, 8600 Rockville Pike, Bethesda, MD 20894.

Contact Person: Donald A.B. Lindberg, MD, Director, National Library of Medicine, National Institutes of Health, PHS, DHHS, Bldg. 38, Room 2E17B, Bethesda, MD 20894.

Any interested person may file written comments with the committee by forwarding the statement to the Contact Person listed on this notice. The statement should include the name, address, telephone number and when applicable, the business or professional affiliation of the interested person.

In the interest of security, NIH has instituted stringent procedures for entrance into the building by non-government employees. Persons without a government I.D. will need to show a photo I.D. and sign-in at the security desk upon entering the building.

Information is also available on the Institute's/Center's Home page: *www.nlm.nih.gov/od/bor/bor.html,* where an agenda and any additional information for the meeting will be posted when available.

(Catalogue of Federal Domestic Assistance Program Nos. 93.879, Medical Library Assistance, National Institutes of Health, HHS)

Dated: July 25, 2003.

LaVerne Y. Stringfield,

Director, Office of Federal Advisory Committee Policy.

[FR Doc. 03–19763 Filed 8–1–03; 8:45 am]

BILLING CODE 4140–01–M

DEPARTMENT OF HEALTH AND HUMAN SERVICES

National Institutes of Health

Center for Scientific Review; Notice of Closed Meetings

Pursuant to section 10(d) of the Federal Advisory Committee Act, as amended (5 U.S.C. Appendix 2), notice is hereby given of the following meetings.

The meetings will be closed to the public in accordance with the provisions set forth in secitons 552b(c)(4) and 552b(c)(6), Title 5 U.S.C., as amended. The grant applications and the discussions could disclose confidential trade secrets or commercial property such as patentable material, and personal information concerning individuals associated with the grant applications, the disclosure of which would constitute a clearly unwarranted invasion of personal privacy.

Name of Committee: Center for Scientific Review Special Emphasis Panel Immunology—Autoimmunity and Innate Immunity.

Date: July 31, 2003.

Time: 1 p.m. to 5 p.m.

Agenda: To review and evaluate grant applications.

Place: National Institutes of Health, 6701 Rockledge Drive, Bethesda, MD 20892, (Telephone Conference Call).

Contact Person: Samuel C. Edwards, PhD, Scientific Review Administrator, Center for Scientific Review, National Institutes of Health, 6701 Rockledge Drive, Room 4200, MSC 7812, Bethesda, MD 20892, (301) 435–1152, *edwardss@csr.nih.gov.*

This notice is being published less than 15 days prior to the meeting due to the timing limitations imposed by the review and funding cycle.

Name of Committee: Center for Scientific Review Special Emphasis Panel ZRG1 MCHA (2).

Date: July 31, 2003.

Time: 12 p.m. to 1 p.m.

Agenda: To review and evaluate grant applications.

Place: National Institutes of Health, 6701 Rockledge Drive, Bethesda, MD 20892, (Telephone Conference Call).

Contact Person: Robert Lees, PhD, Scientific Review Administrator, Center for Scientific Review, National Institutes of Health, 6701 Rockledge Drive, Room 4182, MSC 7806, Bethesda, MD 20892, (301) 435–2684, *leesro@csr.nih.gov.*

This notice is being published less than 15 days prior to the meeting due to the timing limitations imposed by the review and funding cycle.

Name of Committee: Center for Scientific Review Special Emphasis Panel Autoimmunity Innate and Adaptive Immune Responses.

Date: August 1, 2003.

Time: 1 p.m. to 4 p.m.

Agenda: To review and evaluate grant applications.

Place: National Institutes of Health, 6701 Rockledge Drive, Bethesda, MD 20892, (Telephone Conference Call).

Contact Person: Samuel C. Edwards, PhD, Scientific Review Administrator, Center for Scientific Review, National Institutes of Health, 6701 Rockledge Drive, Room 4200, MSC 7812, Bethesda, MD 20892, (301) 435–1152, *edwardss@csr.nih.gov.*

This notice is being published less than 15 days prior to the meeting due to the timing limitations imposed by the review and funding cycle.

Name of Committee: Center for Scientific Review Special Emphasis Panel, B Cell Epitope Mapping of Pathogens.

Date: August 4, 2003.

Time: 11 a.m. to 12 p.m.

Agenda: To review and evaluate grant applications.

Place: National Institutes of Health, 6701 Rockledge Drive, Bethesda, MD 20892, (Telephone Conference Call).

Contact Person: Joanna M. Pyper, PhD, Scientific Review Administrator, Center for Scientific Review, National Institutes of Health, 6701 Rockledge Drive, Room 3198, MSC 7808, Bethesda, MD 20892, (301) 435–1151, *pyperj@csr.nih.gov.*

This notice is being published less than 15 days prior to the meeting due to the timing limitations imposed by the review and funding cycle.

Name of Committee: Center for Scientific Review Special Emphasis Panel, Mammalian Double-Strand Break and Recombinational Repair.

Date: August 5, 2003.

Time: 3 p.m. to 5 p.m.

Agenda: To review and evaluate grant applications.

Place: National Institutes of Health, 6701 Rockledge Drive, Bethesda, MD 20892, (Telephone Conference Call).

Contact Person: Syed M. Quadri, PhD, Scientific Review Administrator, Center for Scientific Review, National Institutes of Health, 6701 Rockledge Drive, Room 6210, MSC 7804, Bethesda, MD 20892, (301) 435–1211.

This notice is being published less than 15 days prior to the meeting due to the timing limitations imposed by the review and funding cycle.

Name of Committee: Center for Scientific Review Special Emphasis Panel, Molecular Immunology—Class Switch Recombination.

Date: August 7, 2003.

Time: 1 p.m. to 2 p.m.

Agenda: To review and evaluate grant applications.

Place: National Institutes of Health, 6701 Rockledge Drive, Bethesda, MD 20892, (Telephone Conference Call).

Contact Person: Samuel C. Edwards, PhD, Scientific Review Administrator, Center for Scientific Review, National Institutes of Health, 6701 Rockledge Drive, Room 4200, MSC 7812, Bethesda, MD 20892, (301) 435–1152, *edwardss@csr.nih.gov.*

This notice is being published less than 15 days prior to the meeting due to the timing limitations imposed by the review and funding cycle.

Name of Committee: Center for Scientific Review Special Emphasis Panel, Drug Development.

Date: August 7, 2003.

Time: 2 p.m. to 4 p.m.

Agenda: To review and evaluate grant applications.

Place: National Institutes of Health, 6701 Rockledge Drive, Bethesda, MD 20892, (Telephone Conference Call).

Contact Person: Marcia Litwack, PhD, Scientific Review Administrator, Center for Scientific Review, National Institutes of Healh, 6701 Rockledge Drive, Room 6206, MSC 7804, Bethesda, MD 20892, (301) 435–1719.

This notice is being published less than 15 days prior to the meeting due to the timing limitations imposed by the review and funding cycle.

Name of Committee: Center for Scientific Review Special Emphasis Panel, Escherichia coli Chemotaxis.

Date: August 8, 2003.

Time: 3 p.m. to 4 p.m.

Agenda: To review and evaluate grant applications.

Place: National Institutes of Health, 6701 Rockledge Drive, Bethesda, MD 20892, (Telephone Conference Call).

Contact Person: Melody Mills, PhD, Scientific Review Administrator, Center for Scientific Review, National Institutes of Health, 6701 Rockledge Drive MSC 7808, Room 3206, Bethesda, MD 20892, 301–435–0903.

This notice is being published less than 15 days prior to the meeting due to the timing limitations imposed by the review and funding cycle.

(Catalogue of Federal Domestic Assistance Program Nos. 93.306, Comparative Medicine; 93.333, Clinical Research, 93.306, 93.333, 93.337, 93.393–93.396, 93.837–93.844, 93.846–93.878, 93.892, 93.893, National Institutes of Health, HHS)

Dated: July 29, 2003.

LaVerne Y. Stringfield,

Director, Office of Federal Advisory Committee Policy.

[FR Doc. 03–19765 Filed 8–1–03; 8:45 am]

BILLING CODE 4140–01–M

DEPARTMENT OF HOMELAND SECURITY

Coast Guard

[USCG 2003–15778]

Collection of Information Under Review by Office of Management and Budget (OMB): OMB Control Numbers: 1625–0023 (Formerly 2115–0092), 1625–0017 (Formerly 2115–0056), 1625–0044 (Formerly 2115–0542) and 1625–0008 (Formerly 2115–0017)

AGENCY: Coast Guard, DHS.

ACTION: Request for comments.

SUMMARY: In compliance with the Paperwork Reduction Act of 1995, the Coast Guard intends to seek the approval of OMB for the renewal of four Information Collection Requests (ICRs). The ICRs comprise Barge Fleeting Facility Records, Various International Agreement Safety Certificates and Documents, and Outer Continental Shelf (OCS) Activities—Title 33 CFR Subchapter N and Regattas and Marine Parades. Before submitting the ICRs to OMB, the Coast Guard is inviting comments on them as described below.

DATES: Comments must reach the Coast Guard on or before October 3, 2003.

ADDRESSES: To make sure that your comments and related material do not enter the docket [USCG 2003–15778] more than once, please submit them by only one of the following means:

(1) By mail to the Docket Management Facility, U.S. Department of Transportation (DOT), room PL–401, 400 Seventh Street, SW., Washington, DC 20590–0001.

(2) By delivery to room PL–401 on the Plaza level of the Nassif Building, 400 Seventh Street, SW., Washington, DC, between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays. The telephone number is 202–366–9329.

(3) By fax to the Facility at 202–493–2251.

(4) Electronically through the Web site for the Docket Management System at *http://dms.dot.gov.*

(5) Electronically through Federal eRule Portal: *http://www.regulations.gov.*

The Facility maintains the public docket for this Notice. Comments and material received from the public, as well as documents mentioned in this Notice as being available in the docket, will become part of this docket and will be available for inspection or copying at room PL–401 on the Plaza level of the Nassif Building, 400 Seventh Street, SW., Washington, DC, between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays. You may also find this docket on the Internet at *http://dms.dot.gov.*

Copies of the complete ICRs are available through this docket on the Internet at *http://dms.dot.gov,* and also from Commandant (G–CIM–2), U.S. Coast Guard Headquarters, room 6106 (Attn: Barbara Davis), 2100 Second Street, SW., Washington, DC 20593–0001. The telephone number is 202–267–2326.

FOR FURTHER INFORMATION CONTACT: Barbara Davis, Office of Information Management, 202–267–2326, for questions on this document; or Dorothy Beard, Chief, Documentary Services

Division, DOT, 202–366–5149, for questions on the docket.

SUPPLEMENTARY INFORMATION:

Public Participation and Request for Comments

We encourage you to participate in this request for comment by submitting comments and related materials. We will post all comments received, without change, to *http://dms.dot.gov,* and they will include any personal information you have provided. We have an agreement with DOT to use the Docket Management Facility. Please see DOT's ''Privacy Act'' paragraph below.

Submitting comments: If you submit a comment, please include your name and address, identify the docket number for this request for comment [USCG–2003–15778], indicate the specific section of this document to which each comment applies, and give the reason for each comment. You may submit your comments and material by electronic means, mail, fax, or delivery to the Docket Management Facility at the address under **ADDRESSES;** but please submit your comments and material by only one means. If you submit them by mail or delivery, submit them in an unbound format, no larger than 8½ by 11 inches, suitable for copying and electronic filing. If you submit them by mail and would like to know that they reached the Facility, please enclose a stamped, self-addressed postcard or envelope. We will consider all comments and material received during the comment period. We may change this proposed rule in view of them.

Viewing comments and documents: To view comments, as well as documents mentioned in this preamble as being available in the docket, go to *http://dms.dot.gov* at any time and conduct a simple search using the docket number. You may also visit the Docket Management Facility in room PL–401 on the Plaza level of the Nassif Building, 400 Seventh Street, SW., Washington, DC, between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays.

Privacy Act: Anyone can search the electronic form of all comments received into any of our dockets by the name of the individual submitting the comment (or signing the comment, if submitted on behalf of an association, business, labor union, etc.). You may review the Privacy Act Statement of DOT in the **Federal Register** published on April 11, 2000 [65 FR 19477], or you may visit *http://dms.dot.gov.*

Information Collection Requests

1. *Title:* Barge Fleeting Facility Records.

OMB Control Number: 1625–0023.

Summary: This collection of information requires the person-in-charge of a barge fleeting facility to keep records of twice daily inspections of barge moorings and movements of barges and hazardous cargo in and out of the facility.

Need: 33 CFR 165.803 requirements are intended to prevent barges from breaking away from a fleeting facility and drifting downstream out of control in the congested Lower Mississippi River waterway system.

Respondents: Operators of barge fleeting facilities.

Frequency: Daily.

Burden: The estimated burden is 32,092 hours a year.

2. *Title:* Various International Agreement Safety Certificates and Documents.

OMB Control Number: 1625–0017.

Summary: Eleven forms were created due to the adoption of the International Convention for Safety of Life at Sea, 1974 (SOLAS). The 11 forms are evidence of compliance with this convention for U.S. vessels on international voyages. Without the proper certificates or documents, a U.S. vessel could be detained in foreign ports.

Need: SOLAS applies to all mechanically propelled cargo vessels of 500 or more gross tons (GT), and to all mechanically propelled passenger vessels carrying more than 12 passengers that engage in international voyages. SOLAS and title 46 CFR 2.01–25 list certificates and documents that may be issued to vessels.

Respondents: Owners and operators of vessels.

Frequency: On occasion.

Burden: The estimated burden is 16 hours a year.

3. *Title:* Outer Continental Shelf (OCS) Activities—Title 33 CFR Subchapter N.

OMB Control Number: 1625–0044.

Summary: The Outer Continental Shelf Lands Act, as amended, authorizes the Coast Guard to promulgate and enforce regulations promoting the safety of life and property on OCS facilities. Title 33 Subchapter N promulgate the regulations.

Need: The information is needed to ensure compliance with the safety regulations related to OCS activities. The regulations include reporting and recordkeeping requirements for annual inspections of fixed OCS facilities, employee citizenship records, station bills, and emergency evacuation plans.

Respondents: Operators of facilities and vessels engaged in activities on the OCS.

Frequency: On occasion.

Burden: The estimated burden is 5,767 hours a year.

4. *Title:* Regattas and Marine Parades.

OMB Control Number: 1625–0008.

Summary: Title 46 U.S.C. 1233 authorizes the Coast Guard to issue regulations to promote the safety of life on navigable waters during regattas or marine parades. Title 33 CFR 100.15 promulgate the regulations for providing needed information for permitting regattas and marine parades to the Coast Guard.

Need: The Coast Guard needs to determine whether a marine event may present a substantial threat to the safety of human life on navigable waters and which measures are needed to ensure the safety of life during the events. The requirement for sponsors of these events to provide specific information on their events is an efficient means for the Coast Guard to learn of the events and to address environmental impacts of events requiring permits.

Respondents: Sponsors of marine events.

Frequency: On occasion.

Burden: The estimated burden is 3,000 hours a year.

Dated: July 29, 2003.

Clifford I. Pearson,

Director of Information and Technology.

[FR Doc. 03–19749 Filed 8–1–03; 8:45 am]

BILLING CODE 4910–15–P

DEPARTMENT OF HOMELAND SECURITY

Coast Guard

[USCG–2003–15779]

Towing Safety Advisory Committee and National Boating Safety Advisory Council

AGENCY: Coast Guard, DHS.

ACTION: Notice of meeting.

SUMMARY: The Commercial/Recreational Boating Interface Working Group of the Towing Safety Advisory Committee (TSAC) will meet with representatives of the National Boating Safety Advisory Council to discuss issues relating to towboat/barge and recreational boat navigation lights and communications. The meeting will be open to the public.

DATES: The Working Group will meet on Tuesday, August 19, 2003, from 9 a.m. to 3 p.m. The meeting may close early if all business is finished. Written material and requests to make oral presentations should reach the Coast Guard on or before August 15, 2003. Requests to have a copy of your material distributed to each member of the Working Group should reach the Coast Guard on or before August 8, 2003.

ADDRESSES: The Working Group will meet in room 1303, U.S. Coast Guard Headquarters, 2100 Second Street SW., Washington, DC. Send written material and requests to make oral presentations to Mr. Gerald Miante, Commandant (G–MSO–1), U.S. Coast Guard Headquarters, 2100 Second Street SW., Washington, DC 20593–0001. This notice and related documents are available on the Internet at *http://dms.dot.gov* under the docket number USCG–2003–15779.

FOR FURTHER INFORMATION CONTACT: Mr. Miante, Assistant Executive Director of TSAC, telephone 202–267–0214, fax 202–267–4570, or e-mail *gmiante@comdt.uscg.mil.*

SUPPLEMENTARY INFORMATION: Notice of the meeting is given under the Federal Advisory Committee Act, 5 U.S.C. App. 2 (Pub. L. 92–463, 86 Stat.770, as amended).

Procedural

The meeting is open to the public. Please note that the meeting may close early if all business is finished. At the Chair's discretion, members of the public may make oral presentations during the meeting. If you would like to make an oral presentation at the meeting, please notify the Assistant Executive Director no later than August 15, 2003. Written material for distribution at the meeting should reach the Coast Guard no later than August 8, 2003.

Information on Services for Individuals With Disabilities

For information on facilities or services for individuals with disabilities or to request special assistance at the meeting, contact the Assistant Executive Director as soon as possible.

Dated: July 28, 2003.

Howard L. Hime,

Acting Director of Standards, Marine Safety, Security and Environmental Protection.

[FR Doc. 03–19753 Filed 8–1–03; 8:45 am]

BILLING CODE 4910–15–P

DEPARTMENT OF HOMELAND SECURITY

Federal Emergency Management Agency

[FEMA–1477–DR]

Arizona; Amendment No. 1 to Notice of a Major Disaster Declaration

AGENCY: Federal Emergency Management Agency, Emergency Preparedness and Response Directorate, Department of Homeland Security.

ACTION: Notice.

SUMMARY: This notice amends the notice of a major disaster for the State of Arizona (FEMA–1477-DR), dated July 14, 2003, and related determinations.

EFFECTIVE DATE: July 15, 2003.

FOR FURTHER INFORMATION CONTACT: Magda Ruiz, Recovery Division, Federal Emergency Management Agency, Washington, DC 20472, (202) 646–2705.

SUPPLEMENTARY INFORMATION: Notice is hereby given that the incident period for this disaster is closed effective July 15, 2003.

(The following Catalog of Federal Domestic Assistance Numbers (CFDA) are to be used for reporting and drawing funds: 83.537, Community Disaster Loans; 83.538, Cora Brown Fund Program; 83.539, Crisis Counseling; 83.540, Disaster Legal Services Program; 83.541, Disaster Unemployment Assistance (DUA); 83.556, Fire Management Assistance; 83.558, Individual and Household Housing; 83.559, Individual and Household Disaster Housing Operations; 83.560 Individual and Household Program-Other Needs, 83.544, Public Assistance Grants; 83.548, Hazard Mitigation Grant Program.)

Michael D. Brown,

Under Secretary, Emergency Preparedness and Response.

[FR Doc. 03–19718 Filed 8–1–03; 8:45 am]

BILLING CODE 6718–02–P

DEPARTMENT OF HOMELAND SECURITY

Federal Emergency Management Agency

[FEMA–1476–DR]

Indiana; Amendment No. 3 to Notice of a Major Disaster Declaration

AGENCY: Federal Emergency Management Agency, Emergency Preparedness and Response Directorate, Department of Homeland Security.

ACTION: Notice.

SUMMARY: This notice amends the notice of a major disaster declaration for the State of Indiana (FEMA–1476–DR), dated July 11, 2003, and related determinations.

EFFECTIVE DATE: July 28, 2003.

FOR FURTHER INFORMATION CONTACT: Magda Ruiz, Recovery Division, Federal Emergency Management Agency, Washington, DC 20472, (202) 646–2705.

SUPPLEMENTARY INFORMATION: The notice of a major disaster declaration for the State of Indiana is hereby amended to include Public Assistance for the following areas among those areas determined to have been adversely affected by the catastrophe declared a major disaster by the President in his declaration of July 11, 2003:

Adams, Allen, Carroll, Howard, Huntington, Jasper, Kosciusko, Miami, Newton, Parke, Tippecanoe, Warren, and Wells Counties for Public Assistance (already designated for Individual Assistance.)

(The following Catalog of Federal Domestic Assistance Numbers (CFDA) are to be used for reporting and drawing funds: 83.537, Community Disaster Loans; 83.538, Cora Brown Fund Program; 83.539, Crisis Counseling; 83.540, Disaster Legal Services Program; 83.541, Disaster Unemployment Assistance (DUA); 83.556, Fire Management Assistance; 83.558, Individual and Household Housing; 83.559, Individual and Household Disaster Housing Operations; 83.560 Individual and Household Program-Other Needs, 83.544, Public Assistance Grants; 83.548, Hazard Mitigation Grant Program.)

Michael D. Brown,

Under Secretary, Emergency Preparedness and Response.

[FR Doc. 03–19717 Filed 8–1–03; 8:45 am]

BILLING CODE 6718–02–P

DEPARTMENT OF HOMELAND SECURITY

Federal Emergency Management Agency

[FEMA–1475–DR]

Kentucky; Amendment No. 2 to Notice of a Major Disaster Declaration

AGENCY: Federal Emergency Management Agency, Emergency Preparedness and Response Directorate, Department of Homeland Security.

ACTION: Notice.

SUMMARY: This notice amends the notice of a major disaster declaration for the Commonwealth of Kentucky (FEMA–1475–DR), dated July 2, 2003, and related determinations.

EFFECTIVE DATE: July 25, 2003.

FOR FURTHER INFORMATION CONTACT: Magda Ruiz, Recovery Division, Federal

Emergency Management Agency, Washington, DC 20472, (202) 646–2705.

SUPPLEMENTARY INFORMATION: The notice of a major disaster declaration for the Commonwealth of Kentucky is hereby amended to include the following area among those areas determined to have been adversely affected by the catastrophe declared a major disaster by the President in his declaration of July 2, 2003:

Knox County for Individual Assistance (already designated for Public Assistance.)

(The following Catalog of Federal Domestic Assistance Numbers (CFDA) are to be used for reporting and drawing funds: 83.537, Community Disaster Loans; 83.538, Cora Brown Fund Program; 83.539, Crisis Counseling; 83.540, Disaster Legal Services Program; 83.541, Disaster Unemployment Assistance (DUA); 83.556, Fire Management Assistance; 83.558, Individual and Household Housing; 83.559, Individual and Household Disaster Housing Operations; 83.560, Individual and Household Program-Other Needs; 83.544, Public Assistance Grants; 83.548, Hazard Mitigation Grant Program.)

Michael D. Brown,

Under Secretary, Emergency Preparedness and Response.

[FR Doc. 03–19720 Filed 8–1–03; 8:45 am]

BILLING CODE 6718–02–P

DEPARTMENT OF HOMELAND SECURITY

Federal Emergency Management Agency

[FEMA–1471–DR]

Kentucky; Amendment No. 5 to Notice of a Major Disaster Declaration

AGENCY: Federal Emergency Management Agency, Emergency Preparedness and Response Directorate, Department of Homeland Security.

ACTION: Notice.

SUMMARY: This notice amends the notice of a major disaster declaration for the Commonwealth of Kentucky (FEMA–1471–DR), dated June 3, 2003, and related determinations.

EFFECTIVE DATE: July 25, 2003.

FOR FURTHER INFORMATION CONTACT: Magda Ruiz, Recovery Division, Federal Emergency Management Agency, Washington, DC 20472, (202) 646–2705.

SUPPLEMENTARY INFORMATION: The notice of a major disaster declaration for the Commonwealth of Kentucky is hereby amended to include the following area among those areas determined to have been adversely affected by the catastrophe declared a major disaster by the President in his declaration of June 3, 2003:

Knox County for Individual Assistance.

(The following Catalog of Federal Domestic Assistance Numbers (CFDA) are to be used for reporting and drawing funds: 83.537, Community Disaster Loans; 83.538, Cora Brown Fund Program; 83.539, Crisis Counseling; 83.540, Disaster Legal Services Program; 83.541, Disaster Unemployment Assistance (DUA); 83.556, Fire Management Assistance; 83.558, Individual and Household Housing; 83.559, Individual and Household Disaster Housing Operations; 83.560, Individual and Household Program-Other Needs; 83.544, Public Assistance Grants; 83.548, Hazard Mitigation Grant Program.)

Michael D. Brown,

Under Secretary, Emergency Preparedness and Response.

[FR Doc. 03–19721 Filed 8–1–03; 8:45 am]

BILLING CODE 6718–02–P

DEPARTMENT OF HOMELAND SECURITY

Federal Emergency Management Agency

[FEMA–1480–DR]

Nebraska; Major Disaster and Related Determinations

AGENCY: Federal Emergency Management Agency, Emergency Preparedness and Response Directorate, Department of Homeland Security.

ACTION: Notice.

SUMMARY: This is a notice of the Presidential declaration of a major disaster for the State of Nebraska (FEMA–1480–DR), dated July 21, 2003, and related determinations.

EFFECTIVE DATE: July 21, 2003.

FOR FURTHER INFORMATION CONTACT: Magda Ruiz, Recovery Division, Federal Emergency Management Agency, Washington,DC 20472, (202) 646–2705.

SUPPLEMENTARY INFORMATION: Notice is hereby given that, in a letter dated July 21, 2003, the President declared a major disaster under the authority of the Robert T. Stafford Disaster Relief and Emergency Assistance Act, 42 U.S.C. 5121–5206 (the Stafford Act), as follows:

I have determined that the damage in certain areas of the State of Nebraska, resulting from severe storms and tornadoes on June 9, 2003, through July 14, 2003, is of sufficient severity and magnitude to warrant a major disaster declaration under the Robert T. Stafford Disaster Relief and Emergency Assistance Act, 42 U.S.C. 5121–5206 (the Stafford Act). I, therefore, declare that such a major disaster exists in the State of Nebraska.

In order to provide Federal assistance, you are hereby authorized to allocate from funds available for these purposes, such amounts as you find necessary for Federal disaster assistance and administrative expenses.

You are authorized to provide Public Assistance in the designated areas, Hazard Mitigation throughout the State, and any other forms of assistance under the Stafford Act you may deem appropriate. Consistent with the requirement that Federal assistance be supplemental, any Federal funds provided under the Stafford Act for Public Assistance and Hazard Mitigation will be limited to 75 percent of the total eligible costs. If Other Needs Assistance under Section 408 of the Stafford Act is later requested and warranted, Federal funding under that program will also be limited to 75 percent of the total eligible costs.

Further, you are authorized to make changes to this declaration to the extent allowable under the Stafford Act.

The Federal Emergency Management Agency (FEMA) hereby gives notice that pursuant to the authority vested in the Under Secretary for Emergency Preparedness and Response, Department of Homeland Security, under Executive Order 12148, as amended, Justin R. DeMello, of FEMA is appointed to act as the Federal Coordinating Officer for this declared disaster.

I do hereby determine the following areas of the State of Nebraska to have been affected adversely by this declared major disaster:

Cedar, Douglas, Greeley, Howard, Jefferson, McPherson, Perkins, Platte, Stanton, and Thayer Counties for Public Assistance.

All counties within the State of Nebraska are eligible to apply for assistance under the Hazard Mitigation Grant Program.

(The following Catalog of Federal Domestic Assistance Numbers (CFDA) are to be used for reporting and drawing funds: 83.537, Community Disaster Loans; 83.538, Cora Brown Fund Program; 83.539, Crisis Counseling; 83.540, Disaster Legal Services Program; 83.541, Disaster Unemployment Assistance (DUA); 83.556, Fire Management Assistance; 83.558, Individual and Household Housing; 83.559, Individual and Household Disaster Housing Operations; 83.560, Individual and Household Program-Other Needs; 83.544, Public Assistance Grants; 83.548, Hazard Mitigation Grant Program.)

Michael D. Brown,

Under Secretary, Emergency Preparedness and Response.

[FR Doc. 03–19711 Filed 8–1–03; 8:45 am]

BILLING CODE 6718–02–P

DEPARTMENT OF HOMELAND SECURITY

Federal Emergency Management Agency

[FEMA–1478–DR]

Ohio; Amendment No. 1 to Notice of a Major Disaster Declaration

AGENCY: Federal Emergency Management Agency, Emergency Preparedness and Response Directorate, Department of Homeland Security.

ACTION: Notice.

SUMMARY: This notice amends the notice of a major disaster for the State of Ohio (FEMA–1478–DR), dated July 15, 2003, and related determinations.

EFFECTIVE DATE: July 11, 2003.

FOR FURTHER INFORMATION CONTACT: Magda Ruiz, Recovery Division, Federal Emergency Management Agency, Washington, DC 20472, (202) 646–2705.

SUPPLEMENTARY INFORMATION: Notice is hereby given that the incident period for this disaster is closed effective July 11, 2003.

(The following Catalog of Federal Domestic Assistance Numbers (CFDA) are to be used for reporting and drawing funds: 83.537, Community Disaster Loans; 83.538, Cora Brown Fund Program; 83.539, Crisis Counseling; 83.540, Disaster Legal Services Program; 83.541, Disaster Unemployment Assistance (DUA); 83.556, Fire Management Assistance; 83.558, Individual and Household Housing; 83.559, Individual and Household Disaster Housing Operations; 83.560 Individual and Household Program-Other Needs, 83.544, Public Assistance Grants; 83.548, Hazard Mitigation Grant Program.)

Michael D. Brown,

Under Secretary, Emergency Preparedness and Response.

[FR Doc. 03–19715 Filed 8–1–03; 8:45 am]

BILLING CODE 6718–02–P

DEPARTMENT OF HOMELAND SECURITY

Federal Emergency Management Agency

[FEMA–1479–DR]

Texas; Amendment No. 3 to Notice of a Major Disaster Declaration

AGENCY: Federal Emergency Management Agency, Emergency Preparedness and Response Directorate, Department of Homeland Security.

ACTION: Notice.

SUMMARY: This notice amends the notice of a major disaster declaration for the State of Texas (FEMA–1479–DR), dated July 17, 2003, and related determinations.

EFFECTIVE DATE: July 28, 2003.

FOR FURTHER INFORMATION CONTACT: Magda Ruiz, Recovery Division, Federal Emergency Management Agency, Washington, DC 20472, (202) 646–2705.

SUPPLEMENTARY INFORMATION: The notice of a major disaster declaration for the State of Texas is hereby amended to include the following areas among those areas determined to have been adversely affected by the catastrophe declared a major disaster by the President in his declaration of July 17, 2003:

Atascosa and McMullen Counties for Public Assistance.

DeWitt, Frio, Karnes, Live Oak, and San Patricio Counties for Individual Assistance and Public Assistance.

Bee, Brazoria, Galveston, and Goliad Counties for Public Assistance (already designated for Individual Assistance.)

Calhoun, Jackson, Matagorda, Refugio, and Victoria Counties for Category A and Categories C through G under the Public Assistance Program (already designated for Category B under the Public Assistance program and Individual Assistance.)

(The following Catalog of Federal Domestic Assistance Numbers (CFDA) are to be used for reporting and drawing funds: 83.537, Community Disaster Loans; 83.538, Cora Brown Fund Program; 83.539, Crisis Counseling; 83.540, Disaster Legal Services Program; 83.541, Disaster Unemployment Assistance (DUA); 83.556, Fire Management Assistance; 83.558, Individual and Household Housing; 83.559, Individual and Household Disaster Housing Operations; 83.560, Individual and Household Program-Other Needs; 83.544, Public Assistance Grants; 83.548, Hazard Mitigation Grant Program.)

Michael D. Brown,

Under Secretary, Emergency Preparedness and Response.

[FR Doc. 03–19712 Filed 8–1–03; 8:45 am]

BILLING CODE 6718–02–P

DEPARTMENT OF HOMELAND SECURITY

Federal Emergency Management Agency

[FEMA–1479–DR]

Texas; Amendment No. 1 to Notice of a Major Disaster Declaration

AGENCY: Federal Emergency Management Agency, Emergency Preparedness and Response Directorate, Department of Homeland Security.

ACTION: Notice.

SUMMARY: This notice amends the notice of a major disaster declaration for the State of Texas (FEMA–1479–DR), dated July 17, 2003, and related determinations.

EFFECTIVE DATE: July 23, 2003.

FOR FURTHER INFORMATION CONTACT: Magda Ruiz, Recovery Division, Federal Emergency Management Agency, Washington, DC 20472, (202) 646–2705.

SUPPLEMENTARY INFORMATION: The notice of a major disaster declaration for the State of Texas is hereby amended to include the following areas among those areas determined to have been adversely affected by the catastrophe declared a major disaster by the President in his declaration of July 17, 2003:

Bee, Brazoria, Galveston, and Goliad Counties for Individual Assistance.

(The following Catalog of Federal Domestic Assistance Numbers (CFDA) are to be used for reporting and drawing funds: 83.537, Community Disaster Loans; 83.538, Cora Brown Fund Program; 83.539, Crisis Counseling; 83.540, Disaster Legal Services Program; 83.541, Disaster Unemployment Assistance (DUA); 83.556, Fire Management Assistance; 83.558, Individual and Household Housing; 83.559, Individual and Household Disaster Housing Operations; 83.560, Individual and Household Program-Other Needs; 83.544, Public Assistance Grants; 83.548, Hazard Mitigation Grant Program.)

Michael D. Brown,

Under Secretary, Emergency Preparedness and Response.

[FR Doc. 03–19713 Filed 8–1–03; 8:45 am]

BILLING CODE 6718–02–P

DEPARTMENT OF HOMELAND SECURITY

Federal Emergency Management Agency

[FEMA–1479–DR]

Texas; Amendment No. 2 to Notice of a Major Disaster Declaration

AGENCY: Federal Emergency Management Agency, Emergency Preparedness and Response Directorate, Department of Homeland Security.

ACTION: Notice.

SUMMARY: This notice amends the notice of a major disaster for the State of Texas (FEMA–1479–DR), dated July 17, 2003, and related determinations.

EFFECTIVE DATE: July 28, 2003.

FOR FURTHER INFORMATION CONTACT: Magda Ruiz, Recovery Division, Federal Emergency Management Agency, Washington, DC 20472, (202) 646–2705.

SUPPLEMENTARY INFORMATION: Notice is hereby given that the incident period for this disaster is closed effective July 28, 2003.

(The following Catalog of Federal Domestic Assistance Numbers (CFDA) are to be used for reporting and drawing funds: 83.537, Community Disaster Loans; 83.538, Cora Brown Fund Program; 83.539, Crisis Counseling; 83.540, Disaster Legal Services Program; 83.541, Disaster Unemployment Assistance (DUA); 83.556, Fire Management Assistance; 83.558, Individual and Household Housing; 83.559, Individual and Household Disaster Housing Operations; 83.560, Individual and Household Program—Other Needs; 83.544, Public Assistance Grants; 83.548, Hazard Mitigation Grant Program.)

Michael D. Brown,

Under Secretary, Emergency Preparedness and Response.

[FR Doc. 03–19714 Filed 8–1–03; 8:45 am]

BILLING CODE 6718–02–P

DEPARTMENT OF HOMELAND SECURITY

Federal Emergency Management Agency

[FEMA–1479–DR]

Texas; Major Disaster and Related Determinations

AGENCY: Federal Emergency Management Agency, Emergency Preparedness and Response Directorate, Department of Homeland Security.

ACTION: Notice.

SUMMARY: This is a notice of the Presidential declaration of a major disaster for the State of Texas (FEMA–1479–DR), dated July 17, 2003, and related determinations.

EFFECTIVE DATE: July 17, 2003.

FOR FURTHER INFORMATION CONTACT: Magda Ruiz, Recovery Division, Federal Emergency Management Agency, Washington, DC 20472, (202) 646–2705.

SUPPLEMENTARY INFORMATION: Notice is hereby given that, in a letter dated July 17, 2003, the President declared a major disaster under the authority of the Robert T. Stafford Disaster Relief and Emergency Assistance Act, 42 U.S.C. 5121–5206 (the Stafford Act), as follows:

I have determined that the damage in certain areas of the State of Texas, resulting from Hurricane Claudette on July 15, 2003, and continuing, is of sufficient severity and magnitude to warrant a major disaster declaration under the Robert T. Stafford Disaster Relief and Emergency Assistance Act, 42 U.S.C. 5121–5206 (the Stafford Act). I, therefore, declare that such a major disaster exists in the State of Texas.

In order to provide Federal assistance, you are hereby authorized to allocate from funds available for these purposes, such amounts as you find necessary for Federal disaster assistance and administrative expenses.

You are authorized to provide Individual Assistance and assistance for emergency protective measures (Category B) under the Public Assistance program in the designated areas, and Hazard Mitigation throughout the State, and any other forms of assistance under the Stafford Act you may deem appropriate subject to completion of Preliminary Damage Assessments. Direct Federal assistance is authorized. Consistent with the requirement that Federal assistance be supplemental, any Federal funds provided under the Stafford Act for Public Assistance, Hazard Mitigation, and the Other Needs Assistance under Section 408 of the Stafford Act will be limited to 75 percent of the total eligible costs.

Further, you are authorized to make changes to this declaration to the extent allowable under the Stafford Act.

The time period prescribed for the implementation of section 310(a), Priority to Certain Applications for Public Facility and Public Housing Assistance, 42 U.S.C. 5153, shall be for a period not to exceed six months after the date of this declaration.

The Federal Emergency Management Agency (FEMA) hereby gives notice that pursuant to the authority vested in the Under Secretary for Emergency Preparedness and Response, Department of Homeland Security, under Executive Order 12148, as amended, Carlos Mitchell, of FEMA is appointed to act as the Federal Coordinating Officer for this declared disaster.

I do hereby determine the following areas of the State of Texas to have been affected adversely by this declared major disaster:

Calhoun, Jackson, Matagorda, Refugio, and Victoria Counties for Individual Assistance.

Calhoun, Jackson, Matagorda, Refugio, and Victoria Counties for emergency protective measures (Category B) under the Public Assistance program.

All counties within the State of Texas are eligible to apply for assistance under the Hazard Mitigation Grant Program.

(The following Catalog of Federal Domestic Assistance Numbers (CFDA) are to be used for reporting and drawing funds: 83.537, Community Disaster Loans; 83.538, Cora Brown Fund Program; 83.539, Crisis Counseling; 83.540, Disaster Legal Services Program; 83.541, Disaster Unemployment Assistance (DUA); 83.556, Fire Management Assistance; 83.558, Individual and Household Housing; 83.559, Individual and Household Disaster Housing Operations; 83.560, Individual and Household Program-Other Needs; 83.544, Public Assistance Grants; 83.548, Hazard Mitigation Grant Program.)

Michael D. Brown,

Under Secretary, Emergency Preparedness and Response.

[FR Doc. 03–19716 Filed 8–1–03; 8:45 am]

BILLING CODE 6718–02–P

DEPARTMENT OF HOMELAND SECURITY

Federal Emergency Management Agency

[FEMA–1474–DR]

West Virginia; Amendment No. 8 to Notice of a Major Disaster Declaration

AGENCY: Federal Emergency Management Agency, Emergency Preparedness and Response Directorate, Department of Homeland Security.

ACTION: Notice.

SUMMARY: This notice amends the notice of a major disaster declaration for the State of West Virginia (FEMA–1474–DR), dated June 21, 2003, and related determinations.

EFFECTIVE DATE: July 21, 2003.

FOR FURTHER INFORMATION CONTACT: Magda Ruiz, Recovery Division, Federal Emergency Management Agency, Washington, DC 20472, (202) 646–2705.

SUPPLEMENTARY INFORMATION: The notice of a major disaster declaration for the State of West Virginia is hereby amended to include the following areas among those areas determined to have been adversely affected by the catastrophe declared a major disaster by the President in his declaration of June 21, 2003:

Preston County for Individual Assistance and Public Assistance.

Tucker County for Public Assistance.

Doddridge and Putnam Counties for Public Assistance (already designated for Individual Assistance.)

(The following Catalog of Federal Domestic Assistance Numbers (CFDA) are to be used for reporting and drawing funds: 83.537, Community Disaster Loans; 83.538, Cora Brown Fund Program; 83.539, Crisis Counseling; 83.540, Disaster Legal Services Program; 83.541, Disaster Unemployment Assistance (DUA); 83.556, Fire Management Assistance; 83.558, Individual and Household Housing; 83.559, Individual and Household Disaster Housing Operations; 83.560, Individual and Household Program-Other Needs; 83.544, Public Assistance Grants; 83.548, Hazard Mitigation Grant Program.)

Michael D. Brown,

Under Secretary, Emergency Preparedness and Response.

[FR Doc. 03–19719 Filed 8–1–03; 8:45 am]

BILLING CODE 6718–02–P

DEPARTMENT OF HOMELAND SECURITY

Transportation Security Administration

Reports, Forms, and Record Keeping Requirements: Agency Information Collection Activity Under OMB Review; Aviation Security Customer Satisfaction Performance Measurement Passenger Survey

AGENCY: Transportation Security Administration (TSA), DHS.

ACTION: Notice.

SUMMARY: This notice announces that TSA has forwarded the Information Collection Request (ICR) abstracted below to the Office of Management and Budget (OMB) for review and clearance under the Paperwork Reduction Act. The ICR describes the nature of the information collection and its expected burden on the public. TSA published a **Federal Register** notice, with a 60-day comment period soliciting comments, of the following collection of information on May 23, 2003, 68 FR 28242.

DATES: Send your comments by September 3, 2003. A comment to OMB is most effective if OMB receives it within 30 days of publication.

ADDRESSES: Comments may be faxed to the Office of Information and Regulatory Affairs, Office of Management and Budget, Attention: DHS–TSA Desk Officer, at (202) 395–5806.

FOR FURTHER INFORMATION CONTACT: Yani Collins; TSA–03, Office of Strategic Management & Analysis; Transportation Security Administration HQ, West Tower, Suite 1045N; 601 South 12th Street, Arlington, VA 22202–4220; telephone (571) 227–1620; facsimile (571) 227–1927; or e-mail *Yani.Collins@dhs.gov.*

SUPPLEMENTARY INFORMATION:

Transportation Security Administration (TSA)

Title: Aviation Security Customer Satisfaction Performance Measurement Passenger Survey.

Type of Request: New collection.

OMB Control Number: Not yet assigned.

Forms: Aviation Security Customer Satisfaction Performance Measurement Passenger Survey Forms.

Affected Public: Up to 422,000 members of the flying public each year.

Abstract: TSA seeks to provide world-class customer service and world-class security. It also seeks to be a performance-based organization that evaluates its programs, measures its performance, and makes management decisions based on objective, credible data. In order to assess its success in providing world-class customer service, TSA intends to conduct a brief satisfaction survey of passengers at the airport. We will conduct two types of surveys: (1) A statistically-valid survey conducted periodically at groups of major airports each year in order to produce the Customer Satisfaction Index for Aviation Operations (CSI–A), a major agency-wide performance measure, and other system-wide performance measures for program evaluation and process improvement; and (2) targeted surveys conducted at individual airports in order to provide targeted performance measurements for use by TSA on-site management. Surveys will be voluntary and anonymous.

Number of Respondents: 422,000.

Estimated Annual Burden Hours: A cumulative maximum of 35,167 hours annually based on an estimated burden of five minutes per respondent.

TSA is soliciting comments to—

(1) Evaluate whether the proposed information requirement is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility;

(2) Evaluate the accuracy of the agency's estimate of the burden;

(3) Enhance the quality, utility, and clarity of the information to be collected; and

(4) Minimize the burden of the collection of information on those who are to respond, including through the use of appropriate automated, electronic, mechanical, or other technological collection techniques or other forms of information technology.

Issued in Arlington, Virginia, on July 29, 2003.

Susan T. Tracey,

Deputy Chief Administrative Officer.

[FR Doc. 03–19775 Filed 8–1–03; 8:45 am]

BILLING CODE 4910–62–P

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

[Docket No. FR–4820–N–32]

Notice of Proposed Information Collection: Comment Request; Utility Allowance Adjustments

AGENCY: Office of the Assistant Secretary for Housing—Federal Housing Commissioner, HUD.

ACTION: Notice.

SUMMARY: The proposed information collection requirement described below will be submitted to the Office of Management and Budget (OMB) for review, as required by the Paperwork Reduction Act. The Department is soliciting public comments on the subject proposal.

DATES: *Comments Due Date:* October 3, 2003.

ADDRESSES: Interested persons are invited to submit comments regarding this proposal. Comments should refer to the proposal by name and/or OMB Control Number and should be sent to: Wayne Eddins, Reports Management Officer, Department of Housing and Urban Development, 451 7th Street, SW., L'Enfant Plaza Building, Room 8003, Washington, DC 20410 or *Wayne_Eddins@hud.gov.*

FOR FURTHER INFORMATION CONTACT: Beverly J. Miller, Director, Office of Multifamily Asset Management, Department of Housing and Urban Development, 451 7th Street, SW., Washington, DC 20410, telephone (202) 708–3730 (this is not a toll free number) for copies of the proposed forms and other available information.

SUPPLEMENTARY INFORMATION: The Department is submitting the proposed information collection to OMB for review, as required by the Paperwork Reduction Act of 1995 (44 U.S.C. chapter 35, as amended).

This Notice is soliciting comments from members of the public and affected agencies concerning the proposed collection of information to: (1) Evaluate whether the proposed collection is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility; (2) Evaluate the accuracy of the agency's estimate of the burden of the proposed collection of information; (3) Enhance the quality, utility, and clarity of the information to be collected; and (4) Minimize the burden of the collection of information on those who are to respond; including the use of appropriate automated collection techniques or other forms of information technology, e.g., permitting electronic submission of responses.

This Notice also lists the following information:

Title of Proposal: Utility Allowance Adjustments.

OMB Control Number, if applicable: 2502–0352.

Description of the need for the information and proposed use: Multifamily project owners are required to advise the Secretary of the Department of Housing and Urban Development of the need for and request approval of a new utility allowance for tenants. This information is necessary for HUD's review and approval of utility allowance increases of 10 percent or higher.

Agency form numbers, if applicable: None.

Estimation of the total numbers of hours needed to prepare the information collection including number of respondents, frequency of response, and hours of response: The estimated total number of burden hours needed to prepare the information collection is 600; the number of respondents is 1,200 generating approximately 1,200 annual responses; the frequency of response is on occasion; and the estimated time needed to prepare the response is 30 minutes.

Status of the proposed information collection: Extension of a currently approved collection.

Authority: The Paperwork Reduction Act of 1995, 44 U.S.C. chapter 35, as amended.

Dated: July 28, 2003.

Sean G. Cassidy,

General Deputy Assistant Secretary for Housing-Deputy Federal Housing Commissioner.

[FR Doc. 03–19790 Filed 8–1–03; 8:45 am]

BILLING CODE 4210–27–M

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

[Docket No.FR–4815–N–50]

Notice of Submission of Proposed Information Collection to OMB: Report of Additional Classification and Wage Rate

AGENCY: Office of the Chief Information Officer, HUD.

ACTION: Notice.

SUMMARY: The proposed information collection requirement described below has been submitted to the Office of Management and Budget (OMB) for review, as required by the Paperwork Reduction Act. The Department is soliciting public comments on the subject proposal.

This information collection facilitates the addition of needed work classifications and wage rates for employers engaged on HUD-assisted construction projects.

DATES: Comments Due Date: September 3, 2003.

ADDRESSES: Interested persons are invited to submit comments regarding this proposal. Comments should refer to the proposal by name and/or OMB approval number (2501–0011) and should be sent to: Lauren Wittenberg, OMB Desk Officer, Office of Management and Budget, Room 10235, New Executive Office Building, Washington, DC 20503; Fax number (202) 395–6974; E-mail *Lauren_Wittenberg@omb.eop.gov.*

FOR FURTHER INFORMATION CONTACT: Wayne Eddins, Reports Management Officer, AYO, Department of Housing and Urban Development, 451 Seventh Street, SW., Washington, DC 20410; e-mail *Wayne_Eddins@HUD.gov;* telephone (202) 708–2374. This is not a toll-free number. Copies of the proposed forms and other available documents submitted to OMB may be obtained from Mr. Eddins.

SUPPLEMENTARY INFORMATION: The Department has submitted the proposal for the collection of information, as described below, to OMB for review, as required by the Paperwork Reduction Act (44 U.S.C. chapter 35). The Notice lists the following information: (1) The title of the information collection proposal; (2) the office of the agency to collect the information; (3) the OMB approval number, if applicable; (4) the description of the need for the information and its proposed use; (5) the agency form number, if applicable; (6) what members of the public will be affected by the proposal; (7) how frequently information submissions will be required; (8) an estimate of the total number of hours needed to prepare the information submission including number of respondents, frequency of response, and hours of response; (9) whether the proposal is new, an extension, reinstatement, or revision of an information collection requirement; and (10) the name and telephone number of an agency official familiar with the proposal and of the OMB Desk Officer for the Department.

This Notice also lists the following information:

Title of Proposal: Report of Additional Classification and Wage Rate.

OMB Approval Number: 2501–0011.

Form Numbers: HUD–4230A and Instructions.

Description of the Need for the Information and its Proposed Use: This information collection facilitates the addition of needed work classifications and wage rates for employers engaged on HUD-assisted construction projects.

Respondents: Business or other for-profit, State, Local or Tribal Government.

Frequency of Submission: On occasion.

	Number of respondents	Annual responses	×	Hours per response	=	Burden hours
Reporting Burden	500	500		1		500

Total Estimated Burden Hours: 500.

Status: Reinstatement, with change, of previously approved collection for which approval has expired.

Authority: Section 3507 of the Paperwork Reduction Act of 1995, 44 U.S.C. 35, as amended.

Dated: July 29, 2003.

Wayne Eddins,

Departmental Reports Management Officer, Office of the Chief Information Officer.

[FR Doc. 03–19791 Filed 8–1–03; 8:45 am]

BILLING CODE 4210–72–P

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

[Docket No. FR–4815–N–49]

Notice of Submission of Proposed Information Collection to OMB: Grant Application Standard Logic Model

AGENCY: Office of the Chief Information Officer, HUD.

ACTION: Notice.

SUMMARY: The proposed information collection requirement described below will be submitted to the Office of Management and Budget (OMB) for review, as required by the Paperwork Reduction Act. The submission is a request for extension of the current approval to collect information on baseline performance standards. This information replaced various reporting requirements and places greater emphasis on performance and results in grant programs.

The Department is soliciting public comments on the subject proposal.

DATES: *Comments Due Date:* October 3, 2003.

ADDRESSES: Interested persons are invited to submit comments regarding this proposal. Comments should refer to the proposal by name and/or OMB approval number (2535–0114) and should be sent to: Wayne Eddins, Reports Management Officer, AYO, Department of Housing and Urban Development, 451 Seventh Street, Southwest, Washington, DC 20410; e-mail *Wayne_Eddins@HUD.gov.*

FOR FURTHER INFORMATION CONTACT: Barbara Dorf, Director Office of Grants Management and Oversight, AJT, or Dorthera M. Yorkshire, Program Analyst, Office of Grants Management and Oversight, AJT, Department of Housing and Urban Development, 451 Seventh Street, SW, Washington, DC 20410; e-mail *Barbara_Dorf@hud.gov*; or *Dorthera_Yorkshire@hud.gov*; telephone (202) 708–0667. This is not a toll-free number. Copies of available documents submitted to OMB may be obtained from Ms. Yorkshire.

SUPPLEMENTARY INFORMATION: The Department has submitted the proposal for the collection of information, as described below, to OMB for review, as required by the Paperwork Reduction Act (44 U.S.C. chapter 35). The Notice lists the following information: (1) The title of the information collection proposal; (2) the office of the agency to collect the information; (3) the OMB approval number, if applicable; (4) the description of the need for the information and its proposed use; (5) the agency form number, if applicable; (6) what members of the public will be affected by the proposal; (7) how frequently information submissions will be required; (8) an estimate of the total number of hours needed to prepare the information submission including number of respondents, frequency of response, and hours of response; (9) whether the proposal is new, an extension, reinstatement, or revision of an information collection requirement; and (10) the name and telephone number of an agency official familiar with the proposal and of the OMB Desk Officer for the Department.

This Notice also lists the following information:

Title of Proposal: Grant Application Standard Logic Model.

OMB Approval Number: 2535–0114.

Form Numbers: Form HUD–96010.

Description of the Need for the Information and its Proposed Use: Applicants of HUD Federal Financial Assistance will be required to indicate intended results and impacts. Grant recipients must report against baseline performance standards. This standardizes grants progress reporting requirements and promotes greater emphasis on performance and results in grant programs.

Respondents: Individuals, Not-for-profit institutions, State, Local or Tribal Government, Business or other for-profit.

Frequency of Submission: On occasion.

Reporting Burden: This information collection is estimated to total one hour per submission. Of the estimated 11,000 grant applicant/recipients, approximately 6,600 report quarterly and 4,400 report annually. Total annual reporting burden is estimated to 30,800 hours.

Total Estimated Burden Hours: 30,800.

Status: Extension of a currently approved collection.

Authority: Section 3507 of the Paperwork Reduction Act of 1995, 44 U.S.C. 35, as amended.

Dated: July 29, 2003.

Wayne Eddins,

Departmental Reports Management Officer, Office of the Chief Information Officer.

[FR Doc. 03–19792 Filed 8–1–03; 8:45 am]

BILLING CODE 4210–72–P

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

[Docket No. FR–4818–N–08]

Notice of Proposed Information Collection for Public Comment on the Quality Control for Rental Assistance Subsidy Determinations

AGENCY: Office of Policy Development and Research, HUD.

ACTION: Notice.

SUMMARY: The proposed information collection requirement described below will be submitted to the Office of Management and Budget (OMB) for review, as required by the Paperwork Reduction Act. The Department is soliciting public comments on the subject proposal.

DATES: *Comments Due Date:* October 3, 2003.

ADDRESS: Interested persons are invited to submit comments regarding this proposal. Comments should refer to the proposal by name and/or OMB Control Number and should be sent to: Reports Liaison Officer, Office of Policy Development and Research, Department of Housing and Urban Development, 451 7th Street SW., Room 8226, Washington, DC 20410.

FOR FURTHER INFORMATION CONTACT: Joseph P. Riley, Director, Economic Market Analysis Division, Office of Policy Development and Research, Department of Housing and Urban Development, 451 7th Street, SW., Room 8222, Washington, DC 20410; telephone 202–708–9426, extension 5861 (This is not a toll-free number). Copies of the proposed forms and other available documents submitted to OMB may be obtained from Mr. Riley.

SUPPLEMENTARY INFORMATION: The Department will submit the proposed information collection to OMB for review, as required by the Paperwork Reduction Act of 1995 (44 U.S.C. chapter 35, as amended).

This Notice is soliciting comments from members of the public and affected agencies concerning the proposed collection of information to: (1) Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including if the information will have practical utility; (2) Evaluate the accuracy of the agency's estimate of the burden of the proposed collection of information; (3) Enhance the quality, utility, and clarity of the information to be collected; and (4) Minimize the burden of the collection of information on those who are to respond, including through the use of appropriate automated collection techniques or other forms of information technology that will reduce respondent burden (e.g., permitting electronic submission of responses).

This Notice also provides the following information:

Title of Proposal: Quality Control for Rental Assistance Subsidy Determinations.

Description of the Need for Information and Proposed Use: The Department is conducting under contract a study to update its estimates of the extent and type of errors associated with income, rent, and subsidy determinations for the 4.4 million households covered by Public Housing and Section 8 housing subsidies. The Quality Control process involves selecting a nationally representative sample of assisted households to measure the extent and types of errors in rent and income determinations, which in turn cause subsidy errors. On-site tenant interviews, file reviews, third-party income verifications, and income matching with other Federal data are conducted. The data obtained are used to identify the most serious problems and their associated costs. HUD program offices are then responsible for designing and implementing corrective actions. In addition to providing current estimates of error, results will be compared with those from the 2000 study. These comparisons will indicate whether corrective actions initiated since the 2000 study have been effective and if changes in priorities are needed.

The first QC study found that about one-half of the errors measured using on-site tenant interviews and file reviews could not be detected with the 500\58/50059 form data collected by the Department, which is why HUD and other agencies with means-tested programs have determined that on-site reviews and interviews are an essential complement to remote monitoring measures. The 2000 study showed that the calculation errors detectable with 50058/50059 data had further decreased, probably because this data was increasingly subject to automated computational checks.

This study will provide current information on the quality of tenant interviewing (e.g., whether they are they being asked about all sources of income) and the reliability of eligibility determinations and income verification. Legislation passed in 2002 requires that the Department report on the error measurements annually. A 2003 study is being completed, and this proposed data collection approval is for the next three studies.

Members of the Affected Public: Recipients of Public Housing and Section 8 Housing Assistance subsidies.

Estimation of the Total Number of Houses Needed With Those Surveyed to Conduct the Information Collection, Including Number of Respondents, Frequency of Response, and Hours of Response: The researchers will survey approximately 550 PHA/program sponsor staff about (re)certification procedures, training, interview procedures, and problems encountered in conducting (re)certifications. Although more than one staff member may need to be contacted to obtain answers to all questions, the questionnaire will be administered once at each participating project and the interviews are expected to take less than 35 minutes. Researchers will survey approximately 3,000 program participants to obtain information on household composition, expenses, and income. the time required for these interviews will vary, but is estimated to require an average of about 50 minutes per interview.

The time estimates provided are based on the 2000 QC survey. This survey will again make use of Computer Assisted Interviewing (CAI) questionnaires and equipment, which are being used in part because they are known to reduce interview times. This software also provides for consistency checks and ensures that all needed data have been collected, thereby reducing the need for follow-up contacts.

Status of the Proposed information Collection: Pending OMB approval.

Authority: Section 3506 of the paperwork Reduction Act of 1995, 44 U.S.C. chapter 35, as amended.

Dated: July 29, 2003.

Alberto F. Treviño,

Assistant Secretary for Policy Development and Research.

[FR Doc. 03–19793 Filed 8–1–03; 8:45 am]

BILLING CODE 4210–62–M

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

[Docket No. FR–4818–N–09]

Notice of Proposed Information Collection for Public Comment on the Notice of Funding Availability for Research Studies on Homeownership and Affordable Lending

AGENCY: Office of Policy Development and Research, HUD.

ACTION: Notice.

SUMMARY: The proposed information collection requirement described below has been submitted to the Office of Management and Budget (OMB) for approval, as required by the Paperwork Reduction Act. The Department is soliciting public comments on the subject proposal.

DATES: *Comments Due Date:* October 3, 2003.

ADDRESSES: Interested persons are invited to submit comments regarding this proposal. Comments should refer to the proposal by name/or OMB approval number and should be sent to: Reports Liaison Officer, Office of Policy Development and Research, Department of Housing and Urban Development, 451 7th Street, SW., Room 8226, Washington, DC 20410.

FOR FURTHER INFORMATION CONTACT: John L. Gardner, Director, Financial Institutions Regulation Division, Office of Policy Development and Research Housing and Urban Development, 451 Seventh Street, SW., Washington, DC 20410; e-mail *John_L._Garner@HUD.gov;* telephone (202) 708–1464. This is not a toll-free number. Copies of available documents submitted to OMB may be obtained from Mr. Gardner.

SUPPLEMENTARY INFORMATION: This Notice informs the public that the Department of Housing and Urban Development (HUD) has submitted to OMB, for processing, an information collection package with respect to funding research studies on homeownership and affordable lending. This research would fulfill the President's goal of an additional 5.5 million minority homeowners by the end of the decade.

This Notice is soliciting comments from members of the public and affected agencies concerning the proposed collection of information to: (1) 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; (2) Evaluate the accuracy of the agency's estimate of the burden of the proposed collection of information; (3) Enhance the quality, utility, and clarity of the information to be collected; and (4) Minimize the burden of the collection of information on those who are to respond; including through the use of appropriate automated collection techniques or other forms of information technology, e.g., permitting electronic submission of responses.

This Notice also lists the following information:

Title of Proposal: Notice of Funding Availability for Research Studies on Homeownership and Affordable Lending.

Description of Information Collection: A study of homeownership and affordable lending will aid in the formulation of policies in support of the President's goal of increasing the number of minority homeowners.

OMB Control Number: 2528–0228.

Agency Form Numbers: HUD 424, HUD 424–B, HUD 424 CB, HUD 424 CBW, SF LLL, HUD 2880 HUD 2993, HUD 2994, HUD 1044, SF 1199A, HUD 27053, HUD 27054, HUD 269.

Members of Affected Public: Not-for-profit institutions, State, Local or Tribal Government.

Estimation of the total numbers of hours needed to prepare the information collection including number of respondents, frequent of responses, and hours of response: An estimation of the total number of hours needed to prepare the information collection is 1810, number of respondents is 40 for the award phase and 15 for the post-award phase, frequency of response is on occasion and quarterly, and the hours of response is 40 for applicants and an additional 14 for recipients.

Authority: The Paperwork Reduction Act of 1995, 44 U.S.C. chapter 35, as amended.

Dated: July 29, 2003.

Alberto F. Treveño,

Assistant Secretary for Policy Development and Research.

[FR Doc. 03–19794 Filed 8–1–03; 8:45 am]

BILLING CODE 4210–62–M

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

[Docket No. FR–4818–N–10]

Notice of Proposed Information Collection for Public Comment on the Notice of Funding Availability for Research on the Socio-Economic Change in Cities

AGENCY: Office of Policy Development and Research, HUD.

ACTION: Notice.

SUMMARY: The proposed information collection requirement described below has been submitted to the Office of Management and Budget (OMB) for approval, as required by the Paperwork Reduction Act. The Department is soliciting public comments on the subject proposal.

DATES: *Comments Due Date:* October 3, 2003.

ADDRESSES: Interested persons are invited to submit comments regarding this proposal. Comments should refer to the proposal by name/or OMB approval number) and should be sent to: Reports Liaison Officer, Office of Policy Development and Research, Department of Housing and Urban Development, 451 7th Street, SW., Room 8226, Washington, DC 20410.

FOR FURTHER INFORMATION CONTACT: Alastair McFarlane, Economist, Economic Development and Public Finance Division, Office of Policy Development and Research Housing and Urban Development, 451 Seventh Street, SW., Washington, DC 20410; e-mail *Alastair_McFarlane@HUD.gov;* telephone (202) 708–0426. This is not a toll-free number. Copies of available documents submitted to OMB may be obtained from Mr. McFarlane.

SUPPLEMENTARY INFORMATION: This Notice informs the public that the Department of Housing and Urban Development (HUD) has submitted to OMB, for processing, an information collection package with respect to funding research studies on Research on the Socio-Economic Change in Cities. This research would fulfill HUD's goal of improving community quality of life and economic vitality.

This Notice is soliciting comments from members of the public and affected agencies concerning the proposed collection of information to: (1) 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; (2) Evaluate the accuracy of the agency's estimate of the burden of the proposed collection of information; (3) Enhance the quality, utility, and clarity of the information to be collected; and (4) Minimize the burden of the collection of information on those who are to respond; including through the use of appropriate automated collection techniques or other forms of information technology, *e.g.,* permitting electronic submission of responses.

This Notice also lists the following information:

Title of Proposal: Notice of Funding Availability for research on the Socio-Economic Change in Cities.

Description of Information Collection: A study of homeownership and affordable lending will aid in the formulation of policies in support of the President's goal of increasing the number of minority homeowners.

OMB Control Number: 2528–0227.

Agency Form Numbers: HUD 424, HUD 424–B, HUD 424 CB, HUD 424 CBW, SF LLL, HUD 2880 HUD 2993, HUD 2994, HUD 1044, SF 1199A, HUD 27053, HUD 27054, HUD 269.

Members of Affected Public: Not-for-profit institutions, State, Local or Tribal Government.

Estimation of the total numbers of hours needed to prepare the information collection including number of respondents, frequency of responses, and hours of response: An estimation of the total number of hours needed to prepare the information collection is 5,010, number of respondents is 120 for the award phase and 15 for the post-award Phase, frequency of response is on occasion and quarterly, and the hours of response is 40 for applicants and an additional 14 for recipients.

Authority: The Paperwork Reduction Act of 1995, 44 U.S.C. chapter 35, as amended.

Dated: July 29, 2003.

Alberto F. Treviño,

Assistant Secretary for Policy Development and Research.

[FR Doc. 03–19795 Filed 8–1–03; 8:45 am]

BILLING CODE 4210–62–M

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

[Docket No. FR–4837–D–28]

Revocation and Redelegation of Authority Under Section 561 of the Housing and Community Development Act of 1987

AGENCY: Office of the Assistant Secretary for Fair Housing and Equal Opportunity, HUD.

ACTION: Notice of revocation and redelegation of authority.

SUMMARY: The Assistant Secretary for Fair Housing and Equal Opportunity (FHEO) revokes all prior redelegations of authority made within the office of the Assistant Secretary for FHEO under Section 561 of the Housing and Community Development Act of 1987, the Fair Housing Initiatives Program (FHIP), and redelegates this authority to FHEO headquarters and regional staff.

EFFECTIVE DATE: July 25, 2003.

FOR FURTHER INFORMATION CONTACT: Myron P. Newry, Director: FHIP/FHAP Division, Office of Fair Housing and Equal Opportunity, Department of Housing and Urban Development, 451 Seventh Street, SW., Room 5224, Washington, DC 20410–2000. Telephone: (202) 708–2288 Ext. 7095. (This is not a toll-free number.) Hearing- and speech-impaired individuals may access this number through TTY by calling the toll-free Federal Information Relay Service at 1–800–877–8339.

SUPPLEMENTARY INFORMATION: The Fair Housing Initiatives Program contained in the Housing and Community Development Act of 1987 (Pub. L. 100–242, approved February 5, 1988) authorizes the Secretary to provide funding to state and local governments or their agencies, public or private non-profit organizations or other public or private entities formulating or carrying out programs to prevent or eliminate discriminatory housing practices. This enables the recipients to carry out activities designed to obtain enforcement of the rights granted by the federal Fair Housing Act or by substantially equivalent state or local fair housing laws. This also enables the recipients to carry out education and outreach activities designed to inform the public of their rights and obligations under such federal, state or local laws prohibiting discrimination. On May 21, 1988, the Secretary delegated to the Assistant Secretary for FHEO the authority to administer the Fair Housing Initiatives Program, pursuant to 24 CFR 125.104(a). (*See* 53 FR 25583, July 7, 1988.)

Through this notice, the Assistant Secretary for FHEO redelegates to the General Deputy Assistant Secretary for FHEO the authority, under Section 561 of the Housing and Community Act of 1987, to administer the Fair Housing Initiatives Program. The General Deputy Assistant Secretary for FHEO, in turn, redelegates this authority to the Deputy Assistant Secretary for Enforcement and Programs, to the Director of the Office of Enforcement and to the FHEO Hub Directors.

Accordingly, the Assistant Secretary for FHEO and the General Deputy

Assistant Secretary for FHEO redelegate authority as follows:

Section A. Authority Redelegated

The Assistant Secretary for FHEO redelegates to the General Deputy Assistant Secretary for FHEO the authority to act under Section 561 of the Housing and Community Act of 1987 (Pub. L. 100–242, February 5, 1988). The General Deputy Assistant Secretary for FHEO redelegates this authority to the Deputy Assistant Secretary for Enforcement and Programs, to the Director of the Office of Enforcement and to the FHEO Hub Directors.

Section B. Authority Excepted

The authority redelegated in this notice does not include the authority to issue or waive regulations. The authority redelegated to the General Deputy Assistant Secretary for FHEO does not include the authority to determine the appropriate reporting and record maintenance, as provided in 24 CFR 125.104(e), or the authority to waive requirements under 24 CFR part 125 not required by statute, as provided in 24 CFR 125.106.

Section C. Authority Revoked

All prior redelegations of authority made within the office of the Assistant Secretary for FHEO regarding section 561 of the Housing and Community Development Act of 1987, the Fair Housing Initiatives Program, are revoked.

Section D. Authority To Redelegate

The authority redelegated to the Deputy Assistant Secretary for Enforcement and Programs, to the Director of the Office of Enforcement and to the FHEO Hub Directors may not be further redelegated.

Authority: Section 7(d) of the Department of Housing and Urban Development Act, 42 U.S.C. 3535(d).

Dated: July 25, 2003.

Carolyn Y. Peoples,

Assistant Secretary for Fair Housing and Equal Opportunity.

Floyd O. May,

General Deputy Assistant Secretary for Fair Housing and Equal Opportunity.

[FR Doc. 03–19781 Filed 8–1–03; 8:45 am]

BILLING CODE 4210–28–P

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

[Docket No. FR–4837–D–27]

Supersedure and Redelegations of Authority for the Civil Rights Related Program Requirements of HUD Programs

AGENCY: Office of the Assistant Secretary for Fair Housing and Equal Opportunity, HUD.

ACTION: Notice of supersedure and redelegation of authority.

SUMMARY: In this notice, the Assistant Secretary for Fair Housing and Equal Opportunity (FHEO) and the General Deputy Assistant Secretary for FHEO redelegate the authority regarding civil rights related program requirements of HUD programs to FHEO staff. This notice supersedes all prior redelegations of this authority made within the Office of the Assistant Secretary for FHEO.

EFFECTIVE DATE: July 25, 2003.

FOR FURTHER INFORMATION CONTACT: Pamela D. Walsh, Director of Program Standards Division, Office of Fair Housing and Equal Opportunity, Room 5224, Department of Housing and Urban Development, 451 Seventh Street, SW., Washington, DC 20410–2000, telephone (202) 708–2288. (This is not a toll-free number.) Hearing- and speech-impaired individuals may access this number through TTY by calling the toll-free Federal Information Relay Service number at 1–800–877–8339.

SUPPLEMENTARY INFORMATION: In a notice published on March 16, 1995 (60 FR 14294), HUD issued delegations and redelegations regarding civil rights related program requirements of HUD programs. In that notice, HUD officials redelegated this authority to the Directors of the Program Operations and Compliance Centers (POCCs). However, FHEO has since been restructured and the position of POCC Director was eliminated. Through this notice, the Assistant Secretary for FHEO and the General Deputy Assistant Secretary for FHEO redelegate this authority to certain FHEO staff and to the FHEO Hub Directors.

Accordingly, the Assistant Secretary for FHEO and the General Deputy Assistant Secretary for FHEO redelegate authority as follows:

Section A. Authority Redelegated

The Assistant Secretary for FHEO redelegates to the General Deputy Assistant Secretary for FHEO the authority regarding civil rights related program requirements of HUD programs. The General Deputy Assistant Secretary for FHEO redelegates this authority to the Deputy Assistant Secretary for Enforcement and Programs, to the Director of the Office of Programs, and to the FHEO Hub Directors.

Section B. Authority Excepted

The authority redelegated in this notice does not include the authority to issue or to waive regulations.

Section C. Authority To Redelegate

The authority redelegated to the Deputy Assistant Secretary for Enforcement and Programs, to the Director of the Office of Programs, and to the FHEO Hub Directors may not be further redelegated.

Section D. Authority Superseded

All prior redelegations of authority regarding civil rights-related program requirements of HUD programs made within the office of the Assistant Secretary for FHEO to the Directors of POCCs are superseded, including a redelegation published on March 16, 1995 (60 FR 14294).

Authority: Section 7(d) of the Department of Housing and Urban Development (42 U.S.C. 3535(d)).

Dated: July 25, 2003.

Carolyn Y. Peoples,

Assistant Secretary for Fair Housing and Equal Opportunity.

Floyd O. May,

General Deputy Assistant Secretary for Fair Housing and Equal Opportunity.

[FR Doc. 03–19782 Filed 8–1–03; 8:45 am]

BILLING CODE 4210–28–P

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

[Docket No. FR–4837–D–26]

Revocation and Redelegation of Authority Under the Age Discrimination Act of 1975

AGENCY: Office of the Assistant Secretary for Fair Housing and Equal Opportunity, HUD.

ACTION: Notice of revocation and redelegation of authority.

SUMMARY: The Assistant Secretary for Fair Housing and Equal Opportunity (FHEO) revokes all prior redelegations of authority made within the Office of the Assistant Secretary for FHEO under the Age Discrimination Act of 1975, and redelegates this authority, with a noted exception, to the General Deputy Assistant Secretary for FHEO, who in turn redelegates certain authority to the Deputy Assistant Secretary for

Enforcement, and Programs to the Director of the Office of Enforcement and to the FHEO Hub Directors.

EFFECTIVE DATE: July 25, 2003.

FOR FURTHER INFORMATION CONTACT: Milton Turner, Director, Compliance and Disability Rights Division, Office of Fair Housing and Equal Opportunity, Room 5240, Department of Housing and Urban Development, 451 Seventh Street, SW., Washington, DC 20410–2000, telephone: (202) 708–2333. (This is not a toll-free number.) Hearing- and speech-impaired individuals may access this number through TTY by calling the toll-free Federal Information Relay Service number at 1–800–877–8339.

SUPPLEMENTARY INFORMATION: In a notice published concurrently with this notice, the Secretary delegated to the Assistant Secretary for FHEO the authority to act under the Age Discrimination Act of 1975. In this notice, the Assistant Secretary for FHEO redelegates this authority, with a noted exception, to the General Deputy Assistant Secretary for FHEO. The General Deputy Assistant Secretary for FHEO, in turn, redelegates certain authority to the Deputy Assistant Secretary for Enforcement and Programs, to the Director of the Office of Enforcement and to the FHEO Hub Directors.

Accordingly, the Assistant Secretary for FHEO and the General Deputy Assistant Secretary for FHEO redelegate authority as follows:

Section A. Authority Redelegated

The Assistant Secretary for FHEO redelegates to the General Deputy Assistant Secretary for FHEO the authority to act under the Age Discrimination Act of 1975. The General Deputy Assistant Secretary for FHEO redelegates this authority to the Deputy Assistant Secretary for Enforcement and Programs, to the Director of the Office of Enforcement, and to the FHEO Hub Directors.

Section B. Authority Excepted

The authority redelegated does not include the authority to issue or waive regulations.

Section C. Authority Revoked

All prior redelegations of authority made within the office of the Assistant Secretary for FHEO under the Age Discrimination Act of 1975 are revoked.

Section D. Authority To Redelegate

The authority redelegated to the Deputy Assistant Secretary for Enforcement and Programs, to the Director of the Office of Enforcement, and to the FHEO Hub Directors may not be further redelegated.

Authority: Section 7(d) of the Department of Housing and Urban Development Act (42 U.S.C. 3535(d)).

Dated: July 25, 2003.

Carolyn Y. Peoples,

Assistant Secretary for Fair Housing and Equal Opportunity.

Floyd O. May,

General Deputy Assistant Secretary for Fair Housing and Equal Opportunity.

[FR Doc. 03–19783 Filed 8–1–03; 8:45 am]

BILLING CODE 4210–28–P

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

[Docket No. FR–4837–D–24]

Revocation and Redelegation of Authority Under Section 504 of the Rehabilitation Act of 1973

AGENCY: Office of the Assistant Secretary for Fair Housing and Equal Opportunity, HUD.

ACTION: Notice of revocation and redelegation of authority.

SUMMARY: The Assistant Secretary for Fair Housing and Equal Opportunity (FHEO) revokes all prior redelegations of authority made within the office of the Assistant Secretary for FHEO under section 504 of the Rehabilitation Act of 1973 and HUD's implementing regulations, and redelegates this authority, with noted exceptions, to the General Deputy Assistant Secretary for FHEO. The General Deputy Assistant Secretary for FHEO, in turn, redelegates certain authority to the Deputy Assistant Secretary for Enforcement and Programs to the Director of the Office of Enforcement and to the FHEO Hub Directors.

EFFECTIVE DATE: July 25, 2003.

FOR FURTHER INFORMATION CONTACT: Milton Turner, Director of Compliance and Disability Rights Division, Office of Fair Housing and Equal Opportunity, Room 5240, Department of Housing and Urban Development, 451 Seventh Street, SW., Washington, DC 20410–2000. Telephone: (202) 708–2333. (This is not a toll-free number.) Hearing- and speech-impaired individuals may access this number through TTY by calling the toll-free Federal Information Relay Service number at 1–800–877–8339.

SUPPLEMENTARY INFORMATION: The Secretary has delegated to the Assistant Secretary for FHEO the authority to act as ''responsible civil rights official'' and ''reviewing civil rights official'' under section 504 of the Rehabilitation Act of 1973 and HUD's implementing regulations in 24 CFR part 8. The Assistant Secretary for FHEO, through this notice, redelegates the authority to act as the ''responsible civil rights official'' to the General Deputy Assistant Secretary for FHEO, who in turn, redelegates this authority to the Deputy Assistant Secretary for Enforcement and Programs, to the Director of the Office of Enforcement and to the FHEO Hub Directors. The Assistant Secretary for FHEO also redelegates the authority to act as ''reviewing civil rights official,'' in accordance with 24 CFR 8.56(h), to the General Deputy Assistant Secretary for FHEO, who in turn further redelegates this authority to the Deputy Assistant Secretary for Enforcement and Programs and to the Director of the Office of Enforcement.

Accordingly, the Assistant Secretary for FHEO and the General Deputy Assistant Secretary for FHEO delegate authority as follows:

Section A. Authority Redelegated

The Assistant Secretary for FHEO redelegates to the General Deputy Assistant Secretary for FHEO the authority to act as the ''responsible civil rights official.'' The General Deputy Assistant Secretary for FHEO redelegates this authority to the Deputy Assistant Secretary for Enforcement and Programs, to the Director of the Office of Enforcement and to the FHEO Hub Directors.

The Assistant Secretary for FHEO redelegates to the General Deputy Assistant Secretary for FHEO authority to act as ''reviewing civil rights official,'' in accordance with in 24 CFR 8.56(h). The General Deputy Assistant Secretary for FHEO redelegates this authority to the Deputy Assistant Secretary for Enforcement and Programs, and to the Director of the Office of Enforcement.

Section B. Authority Excepted

The authority redelegated from the Assistant Secretary for FHEO does not include the authority to issue or waive regulations.

The authority redelegated to the Director of the Office of Enforcement, and to the FHEO Hub Directors does not include the authority, under 24 CFR 8.57(a) and (e)(1), to determine that compliance cannot be effectuated through informal resolution.

The authority redelegated to the General Deputy Assistant Secretary for FHEO, to the Deputy Assistant Secretary for Enforcement and Program, to the Director of the Office of Enforcement, and to the FHEO Hub Directors does not include the authority, as set forth in 24 CFR 8.57(c), to terminate or refuse to grant or continue federal financial assistance for noncompliance.

Section C. Authority Revoked

All prior redelegations of authority made within the office of the Assistant Secretary for FHEO under section 504 of the Rehabilitation Act of 1973 are revoked, including, but not limited to, the redelegaton at 63 FR 11905 (March 11, 1998).

Authority: Section 7(d) of the Department of Housing and Urban Development Act, 42 U.S.C. 3535(d).

Dated: July 25, 2003.

Carolyn Y. Peoples,

Assistant Secretary for Fair Housing and Equal Opportunity.

Floyd O. May,

General Deputy Assistant Secretary for Fair Housing and Equal Opportunity.

[FR Doc. 03–19784 Filed 8–1–03; 8:45 am]

BILLING CODE 4210–28–P

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

[Docket No. FR–4837–D–22]

Revocation and Redelegation of Fair Housing Assistance Program Authority

AGENCY: Office of the Assistant Secretary for Fair Housing and Equal Opportunity, HUD.

ACTION: Notice of revocation and redelegation of authority.

SUMMARY: The Assistant Secretary for Fair Housing and Equal Opportunity (FHEO) revokes all prior redelegations of authority made within the Office of the Assistant Secretary for FHEO under the Fair Housing Assistance Program. Within the exception of redelegation of authority to the FHEO Hub Directors, as set forth in the program regulations, the Assistant Secretary for FHEO redelegates this authority to the General Deputy Assistant Secretary.

EFFECTIVE DATE: July 25, 2003.

FOR FURTHER INFORMATION CONTACT: Karen A. Newton, Deputy Assistant Secretary for Operations and Management, Office of Fair Housing and Equal Opportunity, Department of Housing and Urban Development, 451 Seventh Street, SW., Room 5128, Washington, DC 20410–0001, telephone (202) 708–0768. (This is not a toll-free number.) Hearing- and speech-impaired individuals may access this number through TTY by calling the toll-free Federal Information Relay Service number at (800) 877–8339.

SUPPLEMENTARY INFORMATION: Through regulation (24 CFR 115.101(a)), the Secretary delegated the authority and responsibility for administering the Fair Housing Assistance Program, as provided in 24 CFR part 115, to the Assistant Secretary for FHEO. Also through regulation (24 CFR 115.101(b)), the Assistant Secretary for FHEO redelegated this authority to each Director of a Fair Housing Enforcement Center (now FHEO Hub Directors). In this notice, the Assistant Secretary for FHEO redelegates this authority to the General Deputy Assistant Secretary for FHEO and clarifies the change in title from ''Fair Housing Enforcement Center Directors'' to ''FHEO Hub Directors.''

Section A. Authority Redelegated

The Assistant Secretary for FHEO redelegates the authority and responsibility for administering the Fair Housing Assistance Program, as provided in 24 CFR 115.101(b), to the General Deputy Assistant Secretary for FHEO and to the FHEO Hub Directors. The authority redelegated in this notice does not include the authority to make final decisions concerning the granting and maintenance of substantial equivalency certification and interim certification in accordance with 24 CFR 115.101(b). The authority redelegated in this notice also does not include the authority to issue or waive regulations.

Section B. Nomenclature Clarification

The redelegation of authority from the Assistant Secretary for FHEO to the Fair Housing Enforcement Center Directors remains intact, as set forth in 24 CFR 115.101(b), although the Fair Housing Enforcement Center Directors have been renamed FHEO Hub Directors. The FHEO Hub Directors have the same authority for the administration of the Fair Housing Assistance Program as the Fair Housing Enforcement Center Directors did when 24 CFR part 115 was published in 1996.

Section C. Authority Excepted

The authority redelegated in this notice does not include the authority to issue or waive regulations.

Section D. Authority To Further Redelegate

The General Deputy Assistant Secretary for FHEO may redelegate the authority provided in Section A of this notice. The FHEO Hub Directors may not redelegate the authority provided in 24 CFR 115.101(b).

Section C. Authority Revoked

All prior redelegations of authority made within the Office of the Assistant Secretary for FHEO to administer the Fair Housing Assistance Program are revoked, with the exception of the authority to the FHEO Hub Directors, as set forth in 24 CFR 115.101(b).

Authority: Section 7(d), Department of Housing and Urban Development Act (42 U.S.C. 3535(d)).

Dated: July 25, 2003.

Carolyn Y. Peoples,

Assistant Secretary for Fair Housing and Equal Opportunity.

[FR Doc. 03–19785 Filed 8–1–03; 8:45 am]

BILLING CODE 4210–28–P

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

[Docket No. FR–4837–D–21]

Revocation and Redelegation of Fair Housing Act Complaint Processing Authority

AGENCY: Office of the Assistant Secretary for Fair Housing and Equal Opportunity, HUD.

ACTION: Notice of Revocation and redelegation of authority.

SUMMARY: The Assistant Secretary for Fair Housing and Equal Opportunity (FHEO) revokes all prior redelegations of authority for Fair Housing Act complaint processing made within the Office of the Assistant Secretary for FHEO under the Fair Housing Act and redelegates this authority to FHEO field and headquarters staff.

EFFECTIVE DATE: July 25, 2003.

FOR FURTHER INFORMATION CONTACT: Karen A. Newton, Deputy Assistant Secretary for Operations and Management, Office of Fair Housing and Equal Opportunity, Department of Housing and Urban Development, 451 Seventh Street SW., Room 5128, Washington, DC 20410–0001, telephone (202) 708–0768. (This is not a toll-free number.) Hearing- and speech-impaired individuals may access this number through TTY by calling the toll-free Federal Information Relay Service at (800) 877–8339.

SUPPLEMENTARY INFORMATION: In a March 30, 1989, notice (54 FR 13121), the Secretary of HUD delegated the authority to enforce the Fair Housing Act to the Assistant Secretary for FHEO and the General Counsel, among other Department officials. Since 1989, the Assistant Secretary for FHEO has published several redelegations of Fair Housing Act complaint processing authority to staff. In this notice, the Assistant Secretary for FHEO revokes all prior redelegations of authority for Fair Housing Act complaint processing made by the Assistant Secretary for FHEO under the Fair Housing Act (42 U.S.C. 3601 *et seq.*), and redelegates this authority. Accordingly, the Assistant

Secretary for FHEO redelegates this authority as provided in this notice.

Section A. Authority Redelegated

The Assistant Secretary for FHEO redelegates the authority for Fair Housing Act complaint processing, as provided in 24 CFR part 103, to the General Deputy Assistant Secretary for FHEO.

The General Deputy Assistant Secretary for FHEO further redelegates the authority under 24 CFR part 103, subparts A, B, D (with the exception of the filing of a Secretary-initiated complaint under 24 CFR 103.200(b) and 24 CFR 103.204(a)), E, and F, to the FHEO Hub Directors, to the Deputy Assistant Secretary for Enforcement and Programs, and to the Director of the Office of Enforcement.

The General Deputy Assistant Secretary for FHEO further redelegates the authority, under 24 CFR part 103, subpart C, to the FHEO Hub Directors, and the Deputy Assistant Secretary for Enforcement and Programs.

The General Deputy Assistant Secretary for FHEO further redelegates the authority under 24 CFR 103.510(a) and (d) to the FHEO Hub Directors, to the Deputy Assistant Secretary for Enforcement and Programs and to the Director of the Office of Enforcement, with the exception of pattern and practice referrals to the Attorney General, which are redelegated only to the Deputy Assistant Secretary for Enforcement and Programs, and to the Director of the Office of Enforcement.

The Assistant Secretary for FHEO redelegates to the General Deputy Assistant Secretary for FHEO the authority to reconsider no cause determinations. The General Deputy Assistant Secretary for FHEO further redelegates this authority to the Deputy Assistant Secretary for Enforcement and Programs, and to the Director of the Office of Enforcement.

The Assistant Secretary for FHEO redelegates to the General Deputy Assistant Secretary for FHEO the authority to issue subpoenas related to the *Young* v. *Martinez* litigation. The General Deputy Assistant Secretary for FHEO further redelegates this authority to the Deputy Assistant Secretary for Enforcement and Programs and to the Director of the *Young* Implementation Office.

Section B. Authority To Further Redelegate

The Deputy Assistant Secretary for Enforcement and Programs, the Director of the Office of Enforcement, the FHEO Hub Directors, and the Director of the *Young* Implementation Office may not redelegate the authorities provided in Section A of this notice.

Section C. Authority Revoked

All prior redelegations of authority for Fair Housing complaint processing made within the Office of the Assistant Secretary for FHEO are revoked.

Authority: Section 7(d) of the Department of Housing and Urban Development Act (42 U.S.C. 3535(d)).

Dated: July 25, 2003.

Carolyn Y. Peoples,

Assistant Secretary for Fair Housing and Equal Opportunity.

Floyd O. May,

General Deputy Assistant Secretary for Fair Housing and Equal Opportunity.

[FR Doc. 03–19786 Filed 8–1–03; 8:45 am]

BILLING CODE 4210–28–P

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

[Docket No. FR–4837–D–20]

Revocation and Redelegation of Administrative Authority for Title VI of the Civil Rights Act of 1964

AGENCY: Office of the Assistant Secretary for Fair Housing and Equal Opportunity, HUD.

ACTION: Notice of revocation and redelegation of authority.

SUMMARY: The Assistant Secretary for Fair Housing and Equal Opportunity (FHEO) revokes all prior redelegations of authority under Title VI of the Civil Rights Act of 1964 made within the Office of Assistant Secretary for FHEO and redelegates this authority to act as the ''responsible Department official,'' with noted exceptions, to the General Deputy Assistant Secretary, who in turn, redelegates certain authority to the Deputy Assistant Secretary for Enforcement and Programs, to the Director of the Office of Enforcement, and to the FHEO HUB Directors.

EFFECTIVE DATE: July 25, 2003.

FOR FURTHER INFORMATION CONTACT: Karen A. Newton, Deputy Assistant Secretary for Operations and Management, Office of Fair Housing and Equal Opportunity, Department of Housing and Urban Development, 451 Seventh Street, SW., Room 5128, Washington, DC 20410–0001, telephone (202) 708–0768. (This is not a toll-free number.) Hearing- and speech-impaired individuals may access this number through TTY by calling the toll-free Federal Information Relay Service number at (800) 877–8339.

SUPPLEMENTARY INFORMATION: By previous delegation (36 FR 8821, May 13, 1971), the Secretary of HUD delegated the Secretary's authority, with an exception for the authority in 24 CFR 1.4(b)(2)(ii), to act as the ''responsible Department official'' in all matters relating to carrying out the requirements under Title VI of the Civil Rights Act of 1964 (42 U.S.C. 2000d), to the Assistant Secretary for Equal Opportunity (now the Assistant Secretary for FHEO).

The provisions of Title VI are implemented in the regulations in 24 CFR part 1. A new delegation of authority in which the Secretary delegates to the Assistant Secretary for FHEO authority, with noted exceptions, to act as the ''responsible Department official'' in matters relating to the carrying out of the requirements of Title VI of the 1964 Civil Rights Act, is being published concurrently with this redelegation of authority.

Accordingly, in this notice, the Assistant Secretary for FHEO redelegates the authority, with noted exceptions, to act as the ''responsible Department official'' under Title VI of the 1964 Civil Rights Act and its implementing regulations.

Section A. Authority Redelegated

With certain exceptions noted in Section B, the Assistant Secretary for FHEO redelegates to the General Deputy Assistant Secretary for FHEO the authority, under Title VI as provided in 24 CFR part 1, to act as the ''responsible Department official'' in matters delegated to the Assistant Secretary for FHEO. The General Deputy Assistant Secretary for FHEO further redelegates this authority, with noted exceptions noted in Section B, to the Deputy Assistant Secretary for Enforcement and Programs, to the Director of the Office of Enforcement, and to the FHEO Hub Directors.

Section B. Authority Excepted

The authority redelegated in this notice does not include the authority to issue or to waive regulations. The authority redelegated by the Assistant Secretary for FHEO to the General Deputy Assistant Secretary in this notice does not include the authority to terminate, refuse to grant, or refuse to continue federal financial assistance (see 24 CFR 1.8(c)). The authority redelegated by the General Deputy Assistant Secretary for FHEO to the FHEO Hub Directors does not include the authority under 24 CFR 1.8(a) and (d) to refer to the Department of Justice (DOJ) unresolved findings of non-compliance or to seek compliance through referral to DOJ or ''other means authorized by law.''

Section C. Delegations of Authority Revoked

All prior redelegations of authority under Title VI of the Civil Rights Act of 1964 made within the Office of the Assistant Secretary for FHEO are revoked, including the redelegation published on May 13, 1971 (36 FR 8821).

Authority: Section 7(d) of the Department of Housing and Urban Development Act (42 U.S.C. 3535(d)).

Dated: July 25, 2003.

Carolyn Y. Peoples,

Assistant Secretary for Fair Housing and Equal Opportunity.

Floyd O. May,

General Deputy Assistant Secretary for Fair Housing and Equal Opportunity.

[FR Doc. 03–19787 Filed 8–1–03; 8:45 am]

BILLING CODE 4210–28–P

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

[Docket No. FR–4837–D–18]

Revocation and Redelegation of Administrative Authority for Title I, Section 109 of the Housing and Community Development Act of 1974

AGENCY: Office of the Assistant Secretary for Fair Housing and Equal Opportunity, HUD.

ACTION: Notice of revocation and redelegation of authority.

SUMMARY: The Assistant Secretary for Fair Housing and Equal Opportunity (FHEO) revokes all prior redelegations of authority made within the Office of the Assistant Secretary for FHEO under Title I, Section 109 of the Housing and Community Development Act of 1974, and redelegates certain authority to FHEO field and headquarters staff.

EFFECTIVE DATE: July 25, 2003.

FOR FURTHER INFORMATION CONTACT: Karen A. Newton, Deputy Assistant Secretary for Operations and Management, Office of Fair Housing and Equal Opportunity, Department of Housing and Urban Development, 451 Seventh Street, SW., Room 5128, Washington, DC 20410–0001, telephone (202) 708–0768. (This is not a toll-free number.) Hearing- and speech-impaired individuals may access this number through TTY by calling the toll-free Federal Information Relay Service number at (800) 877–8339.

SUPPLEMENTARY INFORMATION: By previous delegation, the Secretary of HUD delegated to the Assistant Secretary of FHEO, with certain exceptions, the authority to act as the "responsible Department official," under Title I, Section 109 of the Housing and Community Development Act of 1974 (42 U.S.C. 5309). (*See* 41 FR 15359, April 12, 1976) The provisions of Section 109 are implemented through HUD's regulations in 24 CFR part 6. (*See* also 24 CFR 6.3, in which the "responsible official" is defined as the Assistant Secretary for FHEO (or the Assistant Secretary's designee).) The Assistant Secretary redelegates the authority under Section 109 and its implementing regulations as provided in this notice.

Section A. Authority Redelegated

The Assistant Secretary for FHEO redelegates to the General Deputy Assistant Secretary for FHEO the authority under Section 109, as provided in 24 CFR 6.10 and 6.11. The General Deputy Assistant Secretary for FHEO further redelegates these authorities, with noted exceptions, to the Deputy Assistant Secretary for Enforcement and Programs to the Director of the Office of Enforcement, and to the FHEO Hub Directors.

Section B. Authority Excepted

The Assistant Secretary for FHEO does not redelegate the authority to notify a relevant Governor or Chief Executive Officer of findings that a recipient is in noncompliance as provided in 24 CFR 6.12.

The authority delegated by the General Deputy Assistant Secretary for FHEO to the FHEO Hub Directors does not include the authority under 24 CFR 6.11(c) to review letters of finding.

Section C. Delegations of Authority Revoked

All prior redelegations of authority made within the Office of the Assistant Secretary for FHEO under Section 109 of the Housing and Community Development Act of 1974 are revoked.

Authority: Section 7(d), Department of Housing and Urban Development Act (42 U.S.C. 3535(d)).

Dated: July 25, 2003.

Carolyn Y. Peoples,

Assistant Secretary for Fair Housing and Equal Opportunity.

Floyd O. May,

General Deputy Assistant Secretary for Fair Housing and Equal Opportunity.

[FR Doc. 03–19788 Filed 8–1–03; 8:45 am]

BILLING CODE 4210–28–P

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

[Docket No. FR–4837–D–29]

Revocation and Redelegation of Authority Under Section 3 of the Housing and Urban Development Act of 1968

AGENCY: Office of the Assistant Secretary for Fair Housing and Equal Opportunity, HUD.

ACTION: Notice of revocation and redelegation of authority.

SUMMARY: The Assistant Secretary for Fair Housing and Equal Opportunity (FHEO) revokes all redelegations of authority made within the Office of the Assistant Secretary for FHEO under Section 3 of the Housing and Community Development Act of 1968. The Assistant Secretary for FHEO redelegates this authority to the General Deputy Assistant Secretary for FHEO.

EFFECTIVE DATE: July 25, 2003.

FOR FURTHER INFORMATION CONTACT: Linda Thompson, Acting Director, Office for Economic Opportunity, Office of Fair Housing and Equal Opportunity, Department of Housing and Urban Development, 451 Seventh Street, SW., Room 5234, Washington, DC 20410–2000; (202) 708–3685. (This is not a toll-free number.) Hearing- and speech-impaired individuals may access this number through TTY by calling the toll-free Federal Information Relay Service number at 1–800–877–8339.

SUPPLEMENTARY INFORMATION: On October 8, 1993 (58 FR 52534), the Department published a proposed rule that implemented Section 3 of the Housing and Urban Development Act of 1968 (Section 3) (12 U.S.C. 1701u), as amended by the Housing and Community Development Act of 1992 (1992 Act). Since its enactment, Section 3 has served as a statutory basis for promoting the award of jobs and contracts, generated from projects receiving HUD financial assistance, to, respectively, low-income residents and businesses of the areas where the projects to be assisted are located. The 1992 Act significantly revised Section 3, but did not alter the objective of Section 3, which is to provide economic opportunities to low-income persons. The 1992 Act strengthened the Section 3 mandate by clarifying the types of HUD financial assistance, activities, and recipients subject to the requirements of Section 3; identifying the specific individuals and businesses who are the intended beneficiaries of the economic opportunities generated from HUD-assisted activities; and establishing the order of priority in which these individuals and businesses should be recruited and solicited for the employment and other economic opportunities generated from HUD-assisted activities. On June 30, 1994 (59 FR 33866), when the interim rule was published, the functions and responsibilities of the Secretary under Section 3 were delegated to the Assistant Secretary for FHEO. (*See* 24 CFR 135.7.) The Assistant Secretary for FHEO was further authorized to redelegate these functions and responsibilities to other employees of HUD, except for the authority to issue rules and regulations under 24 CFR part 135.

Accordingly, the Assistant Secretary for FHEO redelegates authority as follows:

Section A. Authority Redelegated

The Assistant Secretary for FHEO redelegates to the General Deputy Assistant Secretary for FHEO all authority under Section 3 of the Housing and Urban Development Act of 1968, except for the authority to issue or waive regulations.

Section B. Authority Revoked

All prior redelegations of authority made within the Office of the Assistant Secretary for FHEO under Section 3 of the Housing and Community Development Act of 1968 are revoked.

Section C. Authority To Redelegate

The authority redelegated to the General Deputy Assistant Secretary may not be further redelegated.

Authority: Section 7(d) of the Department of Housing and Urban Development Act (42 U.S.C. 3535(d)).

Dated: July 25, 2003.

Carolyn Y. Peoples,

Assistant Secretary for Fair Housing and Equal Opportunity.

Floyd O. May,

General Deputy Assistant Secretary for Fair Housing and Equal Opportunity.

[FR Doc. 03–19789 Filed 8–1–03; 8:45 am]

BILLING CODE 4210–28–P

DEPARTMENT OF THE INTERIOR

Fish and Wildlife Service

Notice of Availability of an Environmental Assessment/Habitat Conservation Plan and Receipt of Application for Construction and Operation of a Residential Development on 78 Acres of the Greenshores Subdivision, Travis County, TX (PK–RE Development)

AGENCY: U.S. Fish and Wildlife Service, Interior.

ACTION: Notice of availability.

SUMMARY: PK–RE Development Co., Inc. (Applicant) has applied to the U.S. Fish and Wildlife Service (Service) for an incidental take permit pursuant to section 10(a)(1)(B) of the Endangered Species Act (Act). The Applicant has been assigned permit number TE–074582–0. The requested permit, which is for a period of 30 years, would authorize the incidental take of the endangered golden-cheeked warbler (*Dendroica chrysoparia*). The proposed take would occur as a result of the construction and operation of a residential development on portions of the 78-acre Greenshores Subdivision, Travis County, Texas.

The Service has prepared the Environmental Assessment/Habitat Conservation Plan (EA/HCP) for the incidental take application. A determination of jeopardy or non-jeopardy to the species and a decision pursuant to the National Environmental Policy Act (NEPA) will not be made until at least 60 days from the date of publication of this notice. This notice is provided pursuant to Section 10(c) of the Act and National Environmental Policy Act regulations (40 CFR 1506.6).

DATES: Written comments on the application should be received on or before October 3, 2003.

ADDRESSES: Persons wishing to review the application may obtain a copy by writing to the Regional Director, U.S. Fish and Wildlife Service, PO Box 1306, Room 4102, Albuquerque, New Mexico 87103. Persons wishing to review the EA/HCP may obtain a copy by written or telephone request to Sybil Vosler, U.S. Fish and Wildlife Service, Ecological Services Office, 10711 Burnet Road, Suite 200, Austin, Texas 78758 (512/490–0057). Documents will be available for public inspection, by written request or by appointment only, during normal business hours (8 a.m. to 4:30 p.m.) at the U.S. Fish and Wildlife Service Office, Austin, Texas. Data or comments concerning the application and EA/HCP should be submitted in writing to the Field Supervisor, U.S. Fish and Wildlife Service Office, Austin, Texas at 10711 Burnet Road, Suite 200, Austin, Texas 78758. Please refer to permit number TE–074582–0 when submitting comments.

FOR FURTHER INFORMATION CONTACT: Sybil Vosler at the U.S. Fish and Wildlife Service, Ecological Services Office, 10711 Burnet Road, Suite 200, Austin, Texas 78758 (512/490–0057).

SUPPLEMENTARY INFORMATION: Section 9 of the Act prohibits the ''taking'' of endangered species such as the golden-cheeked warbler. However, the Service, under limited circumstances, may issue permits to take endangered wildlife species incidental to, and not the purpose of, otherwise lawful activities. Regulations governing permits for endangered species are at 50 CFR 17.22.

APPLICANT: Russell Eppright Custom Homes plans to construct a residential development on portions of the 78-acre Greenshores Subdivision, City of Austin, Travis County, Texas. This action would eliminate approximately 21.7 acres of habitat and adversely affect 25.8 acres, resulting in take of the golden-cheeked warbler. The Applicant proposes to compensate for this incidental take of the golden-cheeked warbler by preserving 63.6 acres of habitat which will be managed in perpetuity for the benefit of the golden-cheeked warbler.

Bryan Arroyo,

Acting Regional Director, Southwest Region, Albuquerque, New Mexico.

[FR Doc. 03–19683 Filed 8–1–03; 8:45 am]

BILLING CODE 4510–55–P

DEPARTMENT OF THE INTERIOR

Fish and Wildlife Service

Notice of Availability of a Safe Harbor Agreement With Assurances and Receipt of Application for an Enhancement of Survival Permit for Activities on the Robert K. Long Ranch in Bastrop County, TX

AGENCY: U.S. Fish and Wildlife Service, Interior.

ACTION: Notice of availability.

SUMMARY: This notice advises the public that Robert K. Long, Sr. (Applicant) has applied to the Fish and Wildlife Service (Service) for an enhancement of survival permit pursuant to section 10(a)(1)(A) of the Endangered Species Act (Act) of 1973, as amended (16 U.S.C. 1531 *et seq.*). The permit application includes a proposed Safe Harbor Agreement (SHA) for the endangered Houston toad (*Bufo houstonensis*) for a period of 10 years.

DATES: Written comments must be received within 30 days of the date of this publication.

ADDRESSES: Persons wishing to review the application may obtain a copy by writing to the Regional Director, U.S. Fish and Wildlife Service, P.O. Box 1306, Room 4102, Albuquerque, New Mexico 87103. Persons wishing to review the SHA may obtain a copy by contacting Paige Najvar, U.S. Fish and Wildlife Service, 10711 Burnet Road, Suite 200, Austin, Texas 78758 (512–490–0057). Documents will be available for public inspection by written request, by appointment only, during normal business hours (8 to 4:30) at the U.S. Fish and Wildlife Service, Austin, Texas. Written data or comments concerning the application and SHA should be submitted to the Supervisor, U.S. Fish and Wildlife Service, 10711 Burnet Road, Suite 200, Austin, Texas 78758 Austin, Texas. Please refer to permit number TE–074530–0 when submitting comments.

FOR FURTHER INFORMATION CONTACT: Paige Najvar at 10711 Burnet Road, Suite 200, Austin, Texas 78758 (512–490–0057; Fax 512–490–0974).

SUPPLEMENTARY INFORMATION: We (the Service) announce the opening of a 30-day comment period and request comments from the public on the Applicant's enhancement of survival permit application and the accompanying proposed SHA. All comments we receive, including names and addresses, will become part of the administrative record and may be released to the public.

Under a Safe Harbor Agreement, participating property owners voluntarily undertake management activities on their property to enhance, restore, or maintain habitat benefitting species listed under the Act. Safe Harbor Agreements encourage private and other non-Federal property owners to implement conservation efforts for listed species by assuring property owners they will not be subjected to increased property use restrictions due to their efforts to attract listed species to their property or increase the numbers or distribution of listed species already on their property. Application requirements and issuance criteria for enhancement of survival permits through Safe Harbor Agreements are found in 50 CFR 17.22 and 17.32.

The Service worked with the Applicant to design and implement conservation measures that are expected to provide a net conservation benefit to the Houston toad in Bastrop County, Texas. Conservation measures the Applicant will undertake according to the Agreement are: (1) Fence an existing pond and an ephemeral wetland so as to exclude cattle during the breeding season, (2) install fencing in a manner that protects important habitat areas and facilitates herd rotation, (3) create a shallow ephemeral pond designed to facilitate and enhance toad breeding success, (4) install alternative water sources for the cattle, (5) thin understory vegetation in woodlands and forests, (6) link ponds and woodlands through strategic location of brush piles and (where feasible) establishment of woodland corridors, (7) develop and implement a prescribed fire plan for the entire Ranch, (8) plant and protect native bunchgrasses, and (9) treat imported red fire ant mounds.

The incidental take of toads may occur from (1) habitat management actions conducted in accordance with the conservation measures in the Agreement, (2) ongoing ranch activities that may have an increased chance of taking a toad if toad numbers increase, as expected, and (3) removal of the improvements, at some point in the future, if the Applicant exercises his authorization to do so under the permit.

We provide this notice pursuant to section 10(c) of the Endangered Species Act and pursuant to implementing regulations for the National Environmental Policy Act (40 CFR 1506.6).

Dated: July 11, 2003.

Stuart C. Leon,

Acting Regional Director, Southwest Region, Albuquerque, New Mexico.

[FR Doc. 03–19684 Filed 8–1–03; 8:45 am]

BILLING CODE 4510–55–P-

DEPARTMENT OF THE INTERIOR

Fish and Wildlife Service

Preparation of an Environmental Impact Statement for Mount Diablo State Park, Contra Costa County, CA

AGENCY: Fish and Wildlife Service, Interior.

ACTION: Notice of intent.

SUMMARY: Pursuant to the National Environmental Policy Act (NEPA), the Fish and Wildlife Service (Service) advises the public that we intend to gather information necessary to prepare, in coordination with the California Department of Parks and Recreations (State Parks), a joint Environmental Impact Statement/Environmental Impact Report (EIS/EIR) on the impacts of the proposed Mount Diablo State Park Habitat Conservation Plan (Plan). The Plan is being prepared under section 10 (a)(1)(B) of the Endangered Species Act (Act). The Plan proposes an 18,000-acre planning area covering the administrative area, including a 1-mile buffer, of Mount Diablo State Park, Contra Costa County, California. The State Parks intends to request an incidental take permit under the Act for two species federally listed as threatened and seven non-listed species that may become listed during the term of the permit. The permit is needed to authorize incidental take of listed species that could occur as a result of implementation activities covered under the Plan.

The Service provides this notice to: (1) Describe the proposed action and possible alternatives; (2) advise other Federal and State agencies, affected Tribes, and the public of our intent to prepare an EIS/EIR; (3) announce the initiation of a public scoping period; and (4) invite public participating in offering suggestions and information on the scope of issues to be included in the EIS/EIR.

DATES: Written comments should be received on or before September 3, 2003, and will be accepted at the public meeting. The meeting date is: Tuesday, August 19, 2003, 7 p.m. to 9 p.m., Walnut Creek, California.

ADDRESSES: Written comments or questions related to the preparation of the EIS/EIR and NEPA process should be submitted to Sheila Larsen, Conservation Planning, U.S. Fish and Wildlife Service, Sacramento Fish and Wildlife Office, 2800 Cottage Way, W–2605, Sacramento, California 95825; FAX (916) 414–6713. The meeting location is: Shadelands Art Center, 111 North Wiget Lane at Ygnacio Valley Road, Walnut Creek, California, 94596.

FOR FURTHER INFORMATION CONTACT: Sheila Larsen, Fish and Wildlife Biologist, Conservation Planning, at the Sacramento Fish and Wildlife Office at (916) 414–6600.

SUPPLEMENTARY INFORMATION:

Reasonable Accommodation

Persons needing reasonable accommodations in order to attend and participate in the public meeting should contact Sheila Larsen as soon as possible (*see* **FOR FURTHER INFORMATION CONTACT**). To allow sufficient time to process requests, please call no later than one week before the public meeting. Information regarding this proposed action is available in alternative formats upon request.

Background

Section 9 of the Act and its implementing Federal regulations prohibit the ''take'' of a species listed as endangered or threatened. Take is defined under the Act as including to harass, harm, pursue, hunt, shoot, wound, kill, trap, capture or to collect listed animal species, or to attempt to engage in such conduct (16 U.S.C. 1538). However, under section 10(a)(1)(B) of the Act, we may issue permits to authorize ''incidental take'' of listed species. ''Incidental take'' is defined by the Act as take that is incidental to, and not the purpose of, carrying out an otherwise lawful activity. Regulations governing permits for threatened and endangered species are found in the Code of Federal Regulations at 50 CFR 17.32, and 17.22.

Currently, two species federally listed as threatened, and seven species that are not listed, are proposed for coverage under the proposed Plan. The listed species are Alameda whipsnake (*Masticophis lateralis euryxanthus*) and California red-legged frog (*Rana aurora draytonii*). The non-listed species are: California tiger salamander (*Ambystoma californiense*), foothill yellow-legged frog (*Rana boylii*), Swainson's hawk (*Buteo swainsoni*), peregrine falcon (*Falco peregrinus anatum*), burrowing owl (*Athene cunicularia*), Mount Diablo bird's-beak (*Cordylanthus nidularius*), and rock sanicle (*Sanicula saxatilis*). Species may be added or deleted during the course of Plan development based on further analysis, new information, agency consultation, and public comment.

The proposed Plan area includes approximately 18,000 acres in west Contra Costa County. The boundaries of the Plan area are generally defined as a 1-mile buffer around Mount Diablo State Park, including the park.

Possible implementation activities that may be covered under the proposed Plan include road and trail development and maintenance, natural resource management, park facilities development and associated infrastructure, park operation and maintenance projects, and special events. For proposed road and trail development and maintenance, activities such as grading roads, repairs due to erosion, minor re-alignment of roads and trails, repaving of existing primary road system, and management of roadside and trail vegetation may occur. For proposed natural resource management, activities such as exotic plant and animal control, habitat restoration and enhancement, and cultural resource surveys and protection may occur. Proposed covered activities under park operation and maintenance projects may include construction or expansion of existing and new park facilities; repair and replacement of fences, water and sewer system; and normal park operation activities such as trash removal, hazard tree removal, maintaining fuel breaks, and snow plowing. Special event activities may include company picnics, stargazing, and athletic events. Under the proposed Plan, the effects of covered activities are expected to be minimized and mitigated through participation in a conservation program, which will be fully described in the Plan. The proposed need of a conservation program is to provide long-term protection of covered species by protecting biological communities in the Plan area.

Components of a proposed conservation program are now under consideration by the Service and State Parks. These components will likely include: Avoidance and minimization measures, monitoring, adaptive management, and mitigation measures consisting of preservation, restoration, and enhancement of habitat.

Environmental Impact Statement/ Report

State Parks has selected Shaw E&I, Inc. (Shaw), to prepare the Draft EIS/ EIR. The joint document will be prepared in compliance with NEPA and the California Environmental Quality Act (CEQA). Although Shaw will prepare the EIS/EIR, the Service will be responsible for the scope and content of the document for NEPA purposes, and State Parks will be responsible for the scope and content of the document for CEQA purposes.

The EIS/EIR will consider a proposed action (issuance of section 10(a)(1)(B) permit), no action (no permit) alternative, and a reasonable range of other alternatives. A detailed description of the proposed action and other alternatives will be included in the EIS/EIR. It is anticipated that several alternatives will be developed during scoping, which may vary by the level of conservation, impacts caused by the proposed activities, permit area, covered species, or a combination of these factors.

The EIS/EIR will also identify potentially significant impacts on biological resources, land use, air quality, water quality, mineral resources, water resources, economics, and other environmental resource issues that could occur directly or indirectly with implementation of the proposed action and other alternatives. For all potentially significant impacts, the EIS/ EIR will identify mitigation measures where feasible to reduce these impacts to a level below significance.

Environmental review of the EIS/EIR will be conducted in accordance with the requirements of NEPA (42 U.S.C. 4321 *et seq.*), its implementing regulations (40 CFR parts 1500–1508), other applicable regulations, and Service procedures for compliance with those regulations. We are publishing this notice in accordance with section 1501.7 of NEPA to obtain suggestions and information from other agencies and the public on the scope of issues and alternatives to be addressed in the EIS/EIR. More specifically, we provide this notice: (1) To describe the proposed action and possible alternatives; (2) to advise other Federal and State agencies, affected Tribes, and the public of our intent to prepare an EIS/EIR; (3) to announce the initiation of a public scoping period; and (4) to obtain suggestions and information on the scope of issues to be included in the EIS/EIR. The primary purpose of the scoping process is to identify, rather than to debate, significant issues related to the proposed action. We invite written comments from interested parties to ensure that the full range of issues related to the permit request are identified. All comments received, including names and addresses, will become part of the official administrative record and may be made available to the public.

Dated: July 29, 2003.

D. Kenneth McDermond,

Deputy Manager, Region 1, California/Nevada Operations Office, Sacramento, California.

[FR Doc. 03–19776 Filed 8–1–03; 8:45 am]

BILLING CODE 4310–55–P

DEPARTMENT OF THE INTERIOR

Minerals Management Service

Agency Information Collection Activities: Submitted for Office of Management and Budget (OMB) Review; Comment Request

AGENCY: Minerals Management Service (MMS), Interior.

ACTION: Notice of an extension of a currently approved information collection (OMB Control Number 1010–0088).

SUMMARY: To comply with the Paperwork Reduction Act of 1995 (PRA), we are notifying the public that we have submitted to OMB an Information Collection Request (ICR) to renew approval of the paperwork requirements in the regulations under 30 CFR Part 227—Delegation to States. This notice also provides the public a second opportunity to comment on the paperwork burden of these regulatory requirements. The ICR is titled ''30 CFR Part 227—Delegation to States.''

DATES: Submit written comments on or before September 3, 2003.

ADDRESSES: You may submit comments either by fax (202) 395–5806 or e-mail (*Ruth_Solomon@omb.eop.gov*) directly to the Office of Information and Regulatory Affairs, OMB, Attention: Desk Officer for the Department of the Interior (OMB Control Number 1010–0088). You may also mail or hand-carry your comments to Sharron L. Gebhardt, Regulatory Specialist, Minerals Management Service, Minerals Revenue Management, P.O. Box 25165, MS 320B2, Denver, Colorado 80225. If you use an overnight courier service, our courier address is Building 85, Room A–614, Denver Federal Center, Denver, Colorado 80225. MMS is unable to accept electronic comments at this time. Therefore, fax your comments to Ms. Gebhardt at (303) 231–3781, include the title of the information collection and the OMB Control Number in your fax (*i.e.* Subject, Reply or Comments section), along with your name, return address and fax number. If you do not receive confirmation that we have received your fax, contact Ms. Gebhardt at (303) 231–3211.

FOR FURTHER INFORMATION CONTACT: Sharron L. Gebhardt, telephone (303) 231–3211 or fax (303) 231–3781. You may also contact Ms. Gebhardt to obtain a copy at no cost of the regulations that require the subject collection of information.

SUPPLEMENTARY INFORMATION:

Title: 30 CFR Part 227, Delegation to States.

OMB Control Number: 1010–0088.

Bureau Form Number: None.

Abstract: The Secretary of the U.S. Department of the Interior (DOI) is responsible for collecting royalties from lessees who produce minerals from leased Federal and Indian lands. The Secretary is required by various laws to manage mineral resources production on Federal and Indian lands, collect the royalties due, and distribute the funds in accordance with those laws. The Secretary also has an Indian trust responsibility to manage Indian lands and seek advice and information from Indian beneficiaries. MMS performs the royalty management functions and assists the Secretary in carrying out DOI's Indian trust responsibility.

The Federal Oil and Gas Royalty Simplification and Fairness Act of 1996 (RSFA), Public Law 104–185, as corrected by Public Law 104–200, amends the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA), 30 U.S.C. 1701 *et seq*. Prior to enactment of RSFA, section 205 of FOGRMA, 30 U.S.C. 1735, provided for the delegation of audits, inspections, and investigations to the States. RSFA amendments to section 205 of FOGRMA provided that other Federal royalty management functions also may be delegated to requesting States. RSFA authorized the following Federal royalty management functions to States:

a. Conducting audits and investigations;

b. Receiving and processing production and royalty reports;

c. Correcting erroneous report data;

d. Performing automated verification; and

e. Issuing demands, subpoenas (except for solid mineral and geothermal leases), orders to perform restructured accounting, and related tolling agreements and notices to lessees or their designees.

Currently, 10 States have delegation agreements to perform audits and investigations, which is the same function previously authorized under FOGRMA in 1982. Since the passage of RSFA and publication of the final rule on August 12, 1997, no States have proposed a delegation agreement to assume the four additional functions authorized by RSFA. When a State performs any of the delegated functions under the 30 CFR 227 regulations, the State also assumes the burden of providing various types of information to MMS. This information, provided to MMS in the course of performing the work of the delegated functions, is the focus of this information collection.

The requirement to respond is voluntary. If a State were to perform the function of processing royalty and production reports, that State would submit proprietary data to MMS, and both the State and MMS are required to safeguard and protect proprietary data. No items of a sensitive nature are collected.

Frequency of Response: Depending on the function being performed, information can be daily, monthly, quarterly, or annually.

Estimated Number and Description of Respondents: 10 States currently have delegation agreements to do audits and investigations. We estimate that one State per year may request to perform the four additional functions authorized by RSFA.

Estimated Annual Reporting and Recordkeeping ''Hour'' Burden: 4,179 hours.

The following chart shows the breakdown of the estimated burden hours by CFR section and paragraph:

STATE RESPONDENT ANNUAL BURDEN HOUR CHART

30 CFR section	Reporting requirement	Burden hours per response	Annual number of responses	Annual burden hours
227.103; 227.107; 227.109; 227.110(a), (b)(1) and (2), (c), (d), and (e); 227.111(a) and (b); 227.805.	If you want MMS to delegate royalty management functions to you, then you must submit a delegation proposal to the MMS Associate Director for Minerals Revenue Management. MMS may extend the 90-day period with your written consent. You may submit a new delegation proposal at any time following a denial * * * and upon request, [MMS] will send a copy of the delegation proposals to trade associations to distribute to their members * * * You may ask MMS to renew the delegation for an additional 3 years no less than 6 months before your 3-year delegation agreement expires. You must submit your renewal request to the MMS Associate Director for Minerals Revenue Management * * * You may submit a new renewal request any time after denial. After the 3-year renewal period for your delegation agreement ends, if you wish to continue performing one or more delegated functions, you must request a new delegation agreement from MMS * * * If you do not request a hearing * * * any other affected person may submit a written request for a hearing to the MMS Associate Director for Minerals Revenue Management. Before the agreement expires, if you wish to continue to perform one or more of the delegated functions you performed under the expired agreement, you must request a new delegation agreement meeting the requirements of this part and the applicable standards. If you want to perform royalty management functions in addition to those authorized under your existing agreement you must request a new delegation * * * After your delegation agreement is terminated, you may apply again for delegation by beginning with the proposal process * * *.	200	3	600
227.112(d) and (e)	At a minimum, you must provide vouchers detailing your expenditures quarterly during the fiscal year; You must maintain adequate books and records to support your vouchers.	4	80	320
227.200(a), (b)(1), (2), (3), (4), and (5); (c), and (d).	* * * You must seek information or guidance from MMS regarding new, complex, or unique issues. Provide complete disclosure of financial results of activities; Maintain correct and accurate records of all mineral-related transactions and accounts; Maintain effective controls and accountability; Maintain effective system of accounts * * *; Maintain adequate royalty and production information * * * Assist MMS in meeting the requirements of * * * GPRA; Maintain all records you obtain or create * * *.	200	10	2,000
227.200(e) and (h); 227.801(a); 227.804.	Provide reports to MMS about your activities under your delegated functions (progress reports) * * * you must provide periodic statistical reports to MMS summarizing the activities you carried out * * *; Help MMS respond to requests for information from other Federal agencies, Congress, and the public * * * You may ask MMS for an extension of time to comply with the notice. In your extension request you must explain why you need more time * * * You may request MMS to terminate your delegation at any time by submitting your written notice of intent 6 months prior to the date on which you want to terminate * * *.	3	80	240
227.200(f); 227.401(e); 227.601(d).	Assist MMS in maintaining adequate reference, royalty, and production databases; access well, lease, agreement, and reporter reference data from MMS, and provide updated information to MMS * * * Access well, lease, agreement, and production reporter or royalty reporter reference data from MMS and provide updated information to MMS * * *.	.5	250	125
227.200(g)	Develop annual work plans * * *	60	10	600
227.400(a) (4), (6); 227.401(d).	If you request delegation of either production report or royalty report processing functions, you must perform * * * timely transmitting production report or royalty report data to MMS and other affected Federal agencies; * * * Providing production data or royalty data to MMS and other affected Federal agencies * * * Timely transmit required production or royalty data to MMS and other affected Federal agencies * * *.	.5	250	125
227.400(c)	You must provide MMS with a copy of any exceptions from reporting and payment requirements for marginal properties and any alternative royalty and payment requirements for unit agreements and communitization agreements you approve.	20	1	20
227.501(c)	Submit accepted and corrected lines to MMS to allow processing in a timely manner * * *.	.5	250	125

STATE RESPONDENT ANNUAL BURDEN HOUR CHART—Continued

30 CFR section	Reporting requirement	Burden hours per response	Annual number of responses	Annual burden hours
227.601(c)	To perform automated verification or production reports or royalty reports, you must: Maintain all documentation and logging procedures * * *.	2	12	24
Total	....	....	946	4,179

Estimated Annual Reporting and Recordkeeping ''Non-hour Cost'' Burden: The non-hour cost burden for one State to assume the four additional functions authorized by RSFA is estimated at $60,000 for electronic processing and imaging capability. Annualized over 3 years, the cost is $20,000.

Public Disclosure Statement: The PRA (44 U.S.C. 3501, *et seq.*) provides that 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.

Comments: Section 3506(c)(2)(A) of the PRA requires each agency ''* * * to provide notice * * * and otherwise consult with members of the public and affected agencies concerning each proposed collection of information * * *.'' Agencies must specifically solicit comments to: (a) Evaluate whether the proposed collection of information is necessary for the agency to perform its duties, including whether the information is useful; (b) evaluate the accuracy of the agency's estimate of the burden of the proposed collection of information; (c) enhance the quality, usefulness, and clarity of the information to be collected; and (d) minimize the burden on the respondents, including the use of automated collection techniques or other forms of information technology.

To comply with the public consultation process, we published a notice in the **Federal Register** on April 8, 2003, (68 FR 17073) announcing that we would submit this ICR to OMB for approval. The notice provided the required 60-day comment period. We received no comments in response to this notice.

If you wish to comment in response to this notice, you may send your comments to the offices listed under the ADDRESSES section of this notice. OMB has up to 60 days to approve or disapprove the information collection but may respond after 30 days. Therefore, to ensure maximum consideration, OMB should receive public comments by September 3, 2003.

Public Comment Policy: We will post all comments in response to this notice on our Web site at *http://www.mrm.mms.gov/Laws_R_D/InfoColl/InfoColCom.htm*. We will also make copies of the comments available for public review, including names and addresses of respondents, during regular business hours at our offices in Lakewood, Colorado. Individual respondents may request that we withhold their home address from the public record, which we will honor to the extent allowable by law. There also may be circumstances in which we would withhold from the rulemaking record a respondent's identity, as allowable by law. If you request that we withhold your name and/or address, state this prominently at the beginning of your comment. However, we will not consider anonymous comments. We will make all submissions from organizations or businesses, and from individuals identifying themselves as representatives or officials of organizations or businesses, available for public inspection in their entirety.

MMS Information Collection Clearance Officer: Jo Ann Lauterbach, (202) 208–7744.

Dated: July 21, 2003.

Lucy Querques Denett,

Associate Director for Minerals Revenue Management.

[FR Doc. 03–19651 Filed 8–1–03; 8:45 am]

BILLING CODE 4310–MR–P

DEPARTMENT OF JUSTICE

Antitrust Division

Notice Pursuant to the National Cooperative Research and Production Act of 1993—DVD Copy Control Association (''DVD CCA'')

Notice is hereby given that, on July 2, 2003, pursuant to Section 6(a) of the National Cooperative Research and Production Act of 1993, 15 U.S.C. 4301 *et seq.* (''the Act''), DVD CCA has filed written notifications simultaneously with the Attorney General and the Federal Trade Commission disclosing changes in its membership status. The notifications were filed for the purpose of extending the Act's provisions limiting the recovery of antitrust plaintiffs to actual damages under specified circumstances. Specifically, CIS Technology, Inc., Taipei Hsien, TAIWAN; DOCdata Benelux (OMM bv), Tilburg, THE NETHERLANDS; EMI Operations Italy S.p.A., Caronno Pertusella, ITALY; Humax Co., Ltd., Gyeonggi-Do, REPUBLIC OF KOREA; Lu Kee Electronic Co., Ltd., Hong Kong, HONG KONG-CHINA; ODS Optical Disc Service GmbH, Dassow, GERMANY; Shanghai HongSheng (Norcent) Technology Co., Ltd., Shanghai, PEOPLE'S REPUBLIC OF CHINA; TAKT Kwaitkowski & Miadzel Sp.J., Boleslaw, POLAND; Trident Microsystems, Inc., Sunnyvale, CA; Videon Central, Inc., State College, PA; and ZheJiang HuaHong Optoelectronics Group Co., Ltd., Hangzhou, PEOPLE'S REPUBLIC OF CHINA have been added as parties to this venture.

Also, Afreey Inc., Taipei, TAIWAN; Alphacast Co. Ltd., Seoul, REPUBLIC OF KOREA; Applied Research Corporation, Taiepei Hsien, TAIWAN; Esonic Technology Corporation, Taipei, TAIWAN; FM Com Corp., Kyungki-Do, REPUBLIC OF KOREA; Friendly CD-Tek Corporation, Taipei, TAIWAN; Goldteck International Inc., Taipei, TAIWAN; Great China Technology Inc., Taipei Hsien, TAIWAN; Gynco Electronics (H.K.) Ltd., Hong Kong, HONG KONG-CHINA; Hanbit System Co., Ltd., Kyonggi-do, REPUBLIC OF KOREA; Hermosa Cysware Ltd., Taipei, TAIWAN; Highlead Technology, Taipei Hsien, TAIWAN; Iavix Technology Co., Ltd., Taipei, TAIWAN; Iomega Corporation, Roy, UT; Jeu Hang Technology Co., Ltd., Taipei, TAIWAN; Jointeck (HK) Limited, Hong Kong, HONG KONG-CHINA; Linux Technology Ltd., Taipei, TAIWAN; Makidol Electronics Co., Ltd., Shenzhen, PEOPLE'S REPUBLIC OF CHINA; Maxwell Productions, LLC, Scottsdale, AZ; MbyN Inc., Kyungki-do, REPUBLIC OF KOREA; Media Dimensions, Inc., Austin, TX; Media Group, Inc., Fremont, CA: Megatron Co., Ltd., Seoul, REPUBLIC OF KOREA; Novac Co., Ltd., Tokyo, JAPAN; Optical Disc Stampers, Orange, CA; Shenzhen WED Development Co., Ltd., Guangdong, PEOPLE'S REPUBLIC OF CHINA; Shunde Xiongfend Electric Industrial Company, Guangdong, PEOPLE'S REPUBLIC OF CHINA; Takaya Corporation, Tokyo, JAPAN; Tanway Electronic Factory, Hong Kong, HONG KONG-CHINA; TVIA, Santa Clara, CA; Unidisc Technology Co., Ltd., Taipei Hsien, TAIWAN; Zen Research NV, Curacao, NETHERLANDS ANTILLES; and Zenix Electronics Limited, Hong Kong, HONG KONG-CHINA have been dropped as parties to this venture. In addition, Ravisent has changed its name to Sonic Solutions, Novato, CA.

No other changes have been made in either the membership or planned activity of the group research project. Membership in this group research project remains open, and DVD CCA intends to file additional written notification disclosing all changes in membership.

On April 11, 2001, DVD CCA filed its original notification pursuant to Section 6(a) of the Act. The Department of Justice published a notice in the **Federal Register** pursuant to Section 6(b) of the Act on August 3, 2001 (66 FR 40727).

The last notification was filed with the Department on April 4, 2003. A notice was published in the **Federal Register** pursuant to Section 6(b) of the Act on May 14, 2003 (68 fr 25905).

Constance K. Robinson,

Director of Operations, Antitrust Division.

[FR Doc. 03–19673 Filed 8–1–03; 8:45 am]

BILLING CODE 4410–11–M

DEPARTMENT OF JUSTICE

Antitrust Division

Notice Pursuant to the National Cooperative Research and Production Act of 1993—Gaming Standards Association (GSA)

Notice is hereby given that, on July 8, 2003, pursuant to Section 6(a) of the National Cooperative Research and Production Act of 1993, 15 U.S.C. 4301 *et seq.* (''the Act''), the Gaming Standards Association (''GSA'') has filed written notifications simultaneously with the Attorney General and the Federal Trade Commission disclosing changes in its membership status. The notifications were filed for the purpose of extending the Act's provisions limiting the recovery of antitrust plaintiffs to actual damages under specified circumstances. Specifically, Alliance Gaming Services, Amsterdam, HOLLAND; Australasian Gaming Machine Manufacturers Association (AGMMA), Crows Nest, New South Wales, AUSTRALIA; BMM North America, Las Vegas, NV; Cadillac Jack, Duluth, CA; Cirsa Interactive, Terrassa, SPAIN; Cyberview Technologies, Inc., Las Vegas, NV; GameTech International, Reno, NV; GGS–US LTD, Las Vegas, NV; Giesecke & Devrient, Dulles, VA; Glory USA, W. Caldwell, NJ; Isle of Capri Casinos, Inc., Biloxi, MS; MBDA, Miami, OK; OLGC, Toronto, Ontario, CANADA; and Soanar, Croydon, Victoria, AUSTRALIA have been added as parties to this venture. Also, IGT—International Game Technology, Reno, NV has been dropped as a party to this venture.

No other changes have been made in either the membership or planned activity of the group research project. Membership in this group research project remains open, and GSA intends to file additional written notification disclosing all changes in membership.

On March 6, 2003, GSA filed its original notification pursuant to section 6(a) of the Act. The Department of Justice published a notice in the **Federal Register** pursuant to section 6(b) of the Act on April 1, 2003 (68 FR 15743).

Constance K. Robinson,

Director of Operations, Antitrust Division.

[FR Doc. 03–19672 Filed 8–01–03; 8:45 am]

BILLING CODE 4410–11–M

DEPARTMENT OF JUSTICE

Antitrust Division

Notice Pursuant to the National Cooperative Research and Production Act of 1993—SEMATECH, Inc. d/b/a International SEMATECH

Notice is hereby given that, on June 16, 2003, pursuant to Section 6(a) of the National Cooperative Research and Production Act of 1993, 15 U.S.C. 4301 *et seq.* (''the Act''), SEMATECH Inc. (which is doing business as International SEMATECH) has filed written notifications simultaneously with the Attorney General and the Federal Trade Commission disclosing changes in its membership and project status. The notifications were filed for the purpose of extending the Act's provisions limiting the recovery of antitrust plaintiffs to actual damages under specified circumstances.

With respect to membership status, Hynix Semiconductor Inc. (formerly known as Hyundai Electronics Industries Company, Ltd.), Kyoungki-do, REPUBLIC OF KOREA; and STMicroelectronics, Geneva, SWITZERLAND have been dropped as parties to this venture.

The scope of the venture has expanded through a new program called the Research and Development (R&D) Foundry. The nature and objectives of the R&D Foundry are to make International SEMATECH's Advanced Technology Development Facility (''ATDF'') available for customized programs and advanced R&D on fee-for-project basis. R&D Foundry customers can be International SEMATECH members, universities, equipment suppliers and other third parties in the industry (including non-member chip makers). Fees from R&D Foundry projects will be used to offset the expense of operating the ATDF. The R&D Foundry customer may be given exclusive access at certain times to tools in the ATDF and, depending on the nature of the project, may have a dedicated area in which to conduct ongoing research. Alternatively, International SEMATECH ATDF employees will perform the work for the R&D Foundry customer. International SEMATECH will provide personnel to manage the R&D Foundry projects. International SEMATECH personnel costs and other costs related to R&D Foundry activities will be separately accounted for. If an International SEMATECH member is also an R&D Foundry customer, its R&D Foundry fee will not be counted toward International SEMATECH membership dues. The R&D Foundry customer will have exclusive access to and ownership of most of the intellectual property (''IP'') resulting from its project.

No other changes have been made in either the membership or planned activity of the group research project. Membership in this group research project remains open, and International SEMATECH intends to file additional written notification disclosing all changes in membership.

On April 22, 1988, International SEMATECH filed its original notification pursuant to Section 6(a) of the Act. The Department of Justice published a notice in the **Federal Register** pursuant to Section 6(b) of the Act on May 19, 1988 (53 FR 17987).

The last notification was filed with the Department on January 19, 2001. A notice was published in the **Federal Register** pursuant to section 6(b) of the Act on April 24, 2001 (66 FR 20686).

Constance K. Robinson,

Director of Operations, Antitrust Division.

[FR Doc. 03–19671 Filed 8–01–03; 8:45 am]

BILLING CODE 4410–11–M

DEPARTMENT OF JUSTICE

Office of Justice Programs

Agency Information Collection Activities: Proposed Collection; Comments Requested

ACTION: 30-Day notice of information collection under review: Compliance with the Statutory Eligibility Requirements of the Violence Against Women Act.

The Department of Justice (DOJ), Office of Justice Programs (OJP) has submitted the following information collection request to the Office of Management and Budget (OMB) for review and approval in accordance with the Paperwork Reduction Act of 1995. The proposed information collection is published to obtain comments from the public and affected agencies. This proposed information collection was previously published in the **Federal Register** Volume 68, Number 66, page 16832 on April 7, 2003, allowing for a 60 day comment period.

The purpose of this notice is to allow for an additional 30 days for public comment until September 3, 2003. This process is conducted in accordance with 5 CFR 1320.10.

Written comments and/or suggestions regarding the items contained in this notice, especially the estimated public burden and associated response time, should be directed to The Office of Management and Budget, Office of Information and Regulatory Affairs, Attention Department of Justice Desk Officer, Washington, DC 20503. Additionally, comments may be submitted to OMB via facsimile to (202)–395–7285.Written comments and suggestions from the public and affected agencies concerning the proposed collection of information are encouraged. Your comments should address one or more of the following four points:

(1) 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;

(2) Evaluate the accuracy of the agencies' estimate of the burden of the proposed collection of information, including the validity of the methodology and assumptions used;

(3) Enhance the quality, utility, and clarity of the information to be collected; and

(4) Minimize the burden of the collection of information on those who are to respond, including through the use of appropriate automated, electronic, mechanical, or other technological collection techniques or other forms of information technology, *e.g.*, permitting electronic submission of responses.

Overview of This Information Collection

(1) *Type of Information Collection:* Reinstatement, without change, of a previously approved collection for which approval has expired.

(2) *Title of the Form/Collection:* Certification of Compliance with the Statutory Eligibility Requirements of the Violence Against Women Act.

(3) *Agency form number, if any, and the applicable component of the Department sponsoring the collection:* The Office of Management and Budget Number for the certification form is 1125/185. The Office on Violence Against Women, Office of Justice Programs, United States Department of Justice is sponsoring the collection.

(4) *Affected public who will be as or required to respond, as well as a brief abstract:* Primary: The affected public includes STOP formula grantees (50 states, the District of Columbia and five territories (Guam, Puerto Rico, American Samoa, Virgin Islands, Northern Mariana Islands)). The STOP Violence Against Women Formula Grant Program was authorized through the Violence Against Women Act of 1994 (VAWA 1994) and reauthorized and amended by the Violence Against Women Act of 2000 (VAWA 2000). Its purpose is to promote a coordinated, multi-disciplinary approach to improving the criminal justice system's response to violence against women. It envisions a partnership among law enforcement, prosecution, courts, and victim advocacy organizations to enhance victim safety and hold offenders accountable for their crimes of violence against women. The Department of Justice's Office on Violence Against Women (OVW) administers the STOP Formula Grant Program funds which must be distributed by STOP state administrators according to statutory formula (as amended by VAWA 2000).

(5) *An estimate of the total number of respondents and the amount of time estimated for an average respondent to respond/reply:* It is estimated that it will take 56 respondents (STOP state administrators) less than one hour to complete the certification form.

(6) *An estimate of the total public burden (in hours) associated with the collection:* The total annual hour burden to complete the certification form is less than 56 hours.

If additional information is required contact: Brenda E. Dyer, Deputy Clearance Officer, United States Department of Justice, Justice Management Division, Policy and Planning Staff, Patrick Henry Building, Suite 1600, 601 D Street NW., Washington, DC 20530.

Dated: July 30, 2003.

Brenda E. Dyer,

Deputy Clearance Officer, Department of Justice.

[FR Doc. 03–19692 Filed 8–1–03; 8:45 am]

BILLING CODE 4410–18–P

DEPARTMENT OF JUSTICE

Office of Justice Programs

Agency Information Collection Activities: Proposed collection; comments requested

Action: 30-Day Notice of information collection under review: Certification of Compliance with the Statutory Eligibility Requirements for Tribal Governments.

The Department of Justice (DOJ), Office of Justice Programs (OJP) has submitted the following information collection request to the Office of Management and Budget (OMB) for review and approval in accordance with the Paperwork Reduction Act of 1995. The proposed information collection is published to obtain comments from the public and affected agencies. This proposed information collection was previously published in the FR Volume 68, Number 66, page 16832 on April 7, 2003, allowing for a 60 day comment period.

The purpose of this notice is to allow for an additional 30 days for public comment until September 3, 2003. This process is conducted in accordance with 5 CFR 1320.10.

Written comments and/or suggestions regarding the items contained in this notice, especially the estimated public burden and associated response time, should be directed to The Office of Management and Budget, Office of Information and Regulatory Affairs, Attention Department of Justice Desk Officer, Washington, DC 20503. Additionally, comments may be submitted to OMB via facsimile to (202) 395–7285.Written comments and suggestions from the public and affected agencies concerning the proposed collection of information are encouraged. Your comments should address one or more of the following four points:

(1) 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;

(2) Evaluate the accuracy of the agencies estimate of the burden of the proposed collection of information, including the validity of the methodology and assumptions used;

(3) Enhance the quality, utility, and clarity of the information to be collected; and

(4) Minimize the burden of the collection of information on those who are to respond, including through the use of appropriate automated, electronic, mechanical, or other technological collection techniques or other forms of information technology, *e.g.*, permitting electronic submission of responses.

Overview of This Information Collection

(1) *Type of Information Collection:* Reinstatement, without change, of a previously approved collection for which approval has expired.

(2) *Title of the Form/Collection:* Certification of Compliance with the Statutory Eligibility Requirements for Tribal Governments.

(3) *Agency form number, if any, and the applicable component of the Department sponsoring the collection:* The Office of Management and Budget Number for the certification form is 1121/186. The Office on Violence Against Women, Office of Justice Programs, United States Department of Justice is sponsoring the collection.

(4) *Affected public who will be as or required to respond, as well as a brief abstract:* Primary: The affected public includes the approximately 100 grantees under the STOP Violence Against Indian Women Discretionary Grant Program. The STOP Violence Against Indian Women Discretionary Grants are designed to develop and strengthen tribal law enforcement and prosecutorial strategies to combat violent crimes against Indian women, as well as develop and strengthen victim services. The Violence Against Women Act of 1994 required that 4 percent of the amount appropriated each year for grants to combat violent crimes against women be made available for grants to Indian tribal governments. The Violence Against Women Act of 2000 increased this amount to 5 percent.

(5) *An estimate of the total number of respondents and the amount of time estimated for an average respondent to respond/reply:* It is estimated that it will take the approximately 100 grantees under the STOP Violence Against Indian Women Discretionary Grant Program less than one hour to complete the certification form.

(6) *An estimate of the total public burden (in hours) associated with the collection:* The total estimated annual hour burden to complete the certification form is less than 100 hours.

If additional information is required contact: Brenda E. Dyer, Deputy Clearance Officer, United States Department of Justice, Justice Management Division, Policy and Planning Staff, Patrick Henry Building, Suite 1600, 601 D Street NW, Washington, DC 20530.

Dated: July 30, 2003.

Brenda E. Dyer,

Deputy Clearance Officer, Department of Justice.

[FR Doc. 03–19693 Filed 8–1–03; 8:45 am]

BILLING CODE 4410–18–P

FEDERAL MINE SAFETY AND HEALTH REVIEW COMMISSION

Sunshine Act Meeting

July 23, 2003.

TIME AND DATE: 10 a.m., Thursday, July 24, 2003.

PLACE: Hearing Room, 9th Floor, 601 New Jersey Avenue, NW., Washington, DC.

STATUS: Open.

MATTERS TO BE CONSIDERED: The Commission will consider and act upon the following in open session: *Secretary of Labor* v. *Black Butte Coal Co.,* Docket Nos. WEST 2001–166–RM and WEST 2002–223. (Issues include whether the Commission should grant interlocutory review on the question of whether the judge erred in denying the operator's motion to dismiss based upon the Secretary's delay in proposing a penalty assessment.)

No earlier announcement of the meeting was possible.

FOR FURTHER INFORMATION CONTACT: Jean Ellen, (202) 434–9950/(202) 708–9300 for TDD Relay/1–800–877–8339 for toll free.

Jean H. Ellen,

Chief Docket Clerk.

[FR Doc. 03–19895 Filed 7–31–03; 12:20 am]

BILLING CODE 6735–01–M

NATIONAL ARCHIVES AND RECORDS ADMINISTRATION

Records Schedules; Availability and Request for Comments

AGENCY: National Archives and Records Administration (NARA).

ACTION: Notice of availability of proposed records schedules; request for comments.

SUMMARY: The National Archives and Records Administration (NARA) publishes notice at least once monthly of certain Federal agency requests for records disposition authority (records schedules). Once approved by NARA, records schedules provide mandatory instructions on what happens to records when no longer needed for current Government business. They authorize the preservation of records of continuing value in the National Archives of the United States and the destruction, after a specified period, of records lacking administrative, legal, research, or other value. Notice is published for records schedules in which agencies propose to destroy records not previously authorized for disposal or reduce the retention period of records already authorized for disposal. NARA invites public comments on such records schedules, as required by 44 U.S.C. 3303a(a).

DATES: Requests for copies must be received in writing on or before September 18, 2003. Once the appraisal of the records is completed, NARA will send a copy of the schedule. NARA staff usually prepare appraisal memorandums that contain additional information concerning the records covered by a proposed schedule. These, too, may be requested and will be provided once the appraisal is completed. Requesters will be given 30 days to submit comments.

ADDRESSES: To request a copy of any records schedule identified in this notice, write to the Life Cycle Management Division (NWML), National Archives and Records Administration (NARA), 8601 Adelphi Road, College Park, MD 20740–6001. Requests also may be transmitted by FAX to 301–837–3698 or by e-mail to *records.mgt@nara.gov.* Requesters must cite the control number, which appears in parentheses after the name of the agency which submitted the schedule, and must provide a mailing address. Those who desire appraisal reports should so indicate in their request.

FOR FURTHER INFORMATION CONTACT: Paul M. Wester, Jr., Director, Life Cycle Management Division (NWML), National Archives and Records Administration, 8601 Adelphi Road, College Park, MD 20740–6001. Telephone: 301–837–3120. E-mail: *records.mgt@nara.gov.*

SUPPLEMENTARY INFORMATION: Each year Federal agencies create billions of records on paper, film, magnetic tape, and other media. To control this accumulation, agency records managers prepare schedules proposing retention periods for records and submit these schedules for NARA's approval, using the Standard Form (SF) 115, Request for Records Disposition Authority. These schedules provide for the timely transfer into the National Archives of historically valuable records and authorize the disposal of all other records after the agency no longer needs them to conduct its business. Some schedules are comprehensive and cover all the records of an agency or one of its major subdivisions. Most schedules, however, cover records of only one office or program or a few series of records. Many of these update previously approved schedules, and some include records proposed as permanent.

No Federal records are authorized for destruction without the approval of the Archivist of the United States. This approval is granted only after a thorough consideration of their administrative use by the agency of origin, the rights of the Government and of private persons directly affected by the Government's activities, and whether or not they have historical or other value.

Besides identifying the Federal agencies and any subdivisions requesting disposition authority, this public notice lists the organizational unit(s) accumulating the records or indicates agency-wide applicability in the case of schedules that cover records that may be accumulated throughout an agency. This notice provides the control number assigned to each schedule, the total number of schedule items, and the number of temporary items (the records proposed for destruction). It also includes a brief description of the temporary records. The records schedule itself contains a full description of the records at the file unit level as well as their disposition. If NARA staff has prepared an appraisal memorandum for the schedule, it too includes information about the records. Further information about the disposition process is available on request.

Schedules Pending

1. Department of the Air Force, Agency-wide (N1–AFU–03–13, 5 items, 5 temporary items). Records relating to identifying and assisting family members of Air Force personnel who are in need of medical and/or early intervention services, including electronic copies of records created using electronic mail and word processing.

2. Department of the Army, Agency-wide (N1–AU–03–15, 3 items, 3 temporary items). Continuity of operations program records accumulated by offices other than the office with Army-wide responsibility. Included are plans, instructions, coordinating actions, initial and interim reports, and final emergency operations reports. Also included are electronic copies of documents created using electronic mail and word processing. This schedule authorizes the agency to apply the proposed disposition instructions to any recordkeeping medium.

3. Department of the Army, Agency-wide (N1–AU–03–16, 3 items, 3 temporary items). Background materials used to prepare studies relating to unconventional warfare and psychological operations, including electronic copies of documents created using electronic mail and word processing. This schedule also authorizes the agency to apply the proposed disposition instructions to any recordkeeping medium. Recordkeeping copies of the studies to which these files relate were previously approved for permanent retention.

4. Department of the Army, Agency-wide (N1–AU–03–20, 2 items, 2 temporary items). Records relating to Army National Guard and Army Reserve incentive programs involving such benefits as enlistment bonuses, educational assistance, and repayment of student loans. Records include determinations, legal opinions, statistics, and reports. Also included are electronic copies of documents created using electronic mail and word processing. This schedule authorizes the agency to apply the proposed disposition instructions to any recordkeeping medium.

5. Department of the Army, Agency-wide (N1–AU–03–21, 3 items, 3 temporary items). Records relating to Army educational incentives and entitlements. Records include documentation on eligible participants and information related to inquiries and corrective actions to aid soldiers and veterans in obtaining educational benefits. Also included are electronic copies of documents created using electronic mail and word processing. This schedule authorizes the agency to apply the proposed disposition instructions to any recordkeeping medium.

6. Department of Energy, Bonneville Power Administration (N1–305–03–3, 6 items, 6 temporary items). Records relating to procurement, materials management, and quality assurance, including such matters as the disposal of excess material and equipment, the agency's quality assurance program, and material specifications. Also included are electronic copies of records created using electronic mail and word processing. This schedule revises retention periods for these items, which were previously approved for disposal.

7. Department of Health and Human Services, Office of the Secretary (N1–468–03–2, 3 items, 3 temporary items). Records relating to weekly conference calls between headquarters and regional offices of the Office of General Counsel. Included are sound recordings, transcriptions, written summaries, and finding aids. Also included are electronic copies of records created using electronic mail and word processing.

8. Department of Homeland Security, Transportation Security Administration (N1–560–03–1, 20 items, 16 temporary items). Records of the Office of Chief Counsel, including such records as general legal files, personnel-related legal assistance files, protests to the Comptroller General, legal subject files, claim files, civil and criminal enforcement files, and international law files. Also proposed for disposal are electronic copies of documents created using word processing and electronic mail. Records proposed for permanent retention include recordkeeping copies of significant litigation files, enacted legislation files, significant regulation and rulemaking files, and formal legal opinion case files.

9. Department of Justice, Drug Enforcement Administration (N1–170–03–07, 6 items, 6 temporary items). Inputs, electronic data, outputs, and documentation associated with the Diversion Validation Tracking and Electronic Filing System, which tracks funding allocated to support the agency's diversion program. Also included are electronic copies of documents created using electronic mail and word processing.

10. Department of State, Office of War Crimes Issues (N1–59–02–2, 2 items, 1 temporary item). Electronic copies of records created using electronic mail and word processing associated with the office's program files. Recordkeeping copies of these records are proposed for permanent retention.

11. Department of the Treasury, Bureau of the Public Debt (N1–53–03–10, 1 item, 1 temporary item). Surveillance tapes of exterior building areas and interior entrance areas. This schedule authorizes the agency to destroy these records after a retention period that is shorter than the retention period included in General Records Schedule 21, Item 18.

12. Department of the Treasury, Bureau of the Public Debt (N1–53–03–11, 5 items, 5 temporary items). Forms, correspondence, and reports needed to process securities transactions and letters and reports relating to attempts to contact owners of unredeemed securities or owners with undeliverable securities or payments. Also included are electronic copies of documents created using electronic mail and word processing.

13. Department of the Treasury, U.S. Mint (N1–104–03–2, 2 items, 1 temporary item). Electronic copies of records created using electronic mail and word processing that are associated with financial operations reports. Recordkeeping copies of these files are proposed for permanent retention.

14. Department of the Treasury, U.S. Mint (N1–104–03–4), 2 items, 2 temporary items). Economic Crimes Unit investigative records. Records include original complaints, transmittal memorandums, and related documents. Also included are electronic copies or records created using electronic mail and word processing.

15. Peace Corps, Office of Overseas Posts (N1–490–02–2, 12 items, 8 temporary items). Records relating to post startup and closeout, funding and other financial matters, and volunteer living allowances and stipends. Also included are electronic copies of records created using word processing and electronic mail. Proposed for permanent retention are recordkeeping copies of briefing books, country welcome books, country graduation books, and legacy reports.

16. Tennessee Valley Authority, Fossil Power Group (N1–142–03–3, 8 items, 6 temporary items). Design and construction drawings documenting the layout of structures and equipment at fossil power plants that are lacking in historical value. Records are maintained in paper and microfilm and as scanned images. Also included are electronic copies of documents created using electronic mail and word processing. Proposed for permanent retention are hard copy and electronic versions of drawings having historical value, such as site general plan drawings, drawings of structures, and switchyard drawings.

Dated: July 25, 2003.

Michael J. Kurtz,

Assistant Archivist for Record Services—Washington, DC.

[FR Doc. 03–19652 Filed 8–1–03; 8:45 am]

BILLING CODE 7515–01–P

NATIONAL LABOR RELATIONS BOARD

Sunshine Act Meeting

AGENCY HOLDING THE MEETING: National Labor Relations Board.

TIME AND DATE: 10 a.m., Tuesday, July 9, 2003.

PLACE: Board Conference Room, Eleventh Floor, 1099 Fourteenth St., NW., Washington, DC 20570.

STATUS: Closed to public observation pursuant to 5 U.S.C. Section 552b(c)(2) (internal personnel rules and practices), (6) (personal privacy), and (9)(B) (disclosure would significantly frustrate implementation of a proposed Agency action).

MATTERS TO BE CONSIDERED: Internal Administrative Matters.

CONTACT PERSON FOR MORE INFORMATION: Lester A. Heltzer, Executive Secretary, Washington, DC 20570, Telephone: (202) 273–1067.

Dated, Washington, DC, July 30, 2003.

By Direction of the Board.

Lester A. Heltzer,

Executive Secretary, National Labor Relations Board.

[FR Doc. 03–19881 Filed 7–31–03; 12:15 am]

BILLING CODE 7545–01–M

NUCLEAR REGULATORY COMMISSION

[Docket No. 030–29288]

Notice of Consideration of License Renewal Request for Decommissioning the Quehanna Site in Karthaus, Pennsylvania and Opportunity To Provide Comments and Request a Hearing

ACTION: Notice of consideration of amendment request to renew license to authorize decommissioning, and opportunity to provide comments and to request a hearing.

FOR FURTHER INFORMATION CONTACT: James Kottan, Project Manager, Decommissioning and Laboratory Branch, Division of Nuclear Materials Safety, Region I, U.S. Nuclear Regulatory Commission, 475 Allendale Road, King of Prussia, PA 19406. Telephone: (610) 337–5214, fax number (610) 337–5269, and/or e-mail *jjk@nrc.gov*.

SUPPLEMENTARY INFORMATION:

I. Introduction

The U.S. Nuclear Regulatory Commission is considering the renewal of By-Product Materials License No. 37–17860–02 (License No. 37–17860–02), issued to the Pennsylvania Department of Environmental Protection, Bureau of Radiation Protection, to authorize decommissioning of the Quehanna Site in Karthaus, Pennsylvania.

The licensee has been performing limited decommissioning of the hot cells at the Quehanna Site in accordance with the conditions described in License No. 37–17860–02. On February 26, 2003, the licensee submitted a license renewal application, including a revised Decommissioning Plan (DP) for the Quehanna Site, to the NRC for review that summarized the decommissioning activities that will be undertaken to remediate the hot cells and other building areas and any contaminated soil. Radioactive contamination at the licensee's Quehanna Site consists of contaminated process piping, soils, and building surfaces contaminated primarily with strontium-90 resulting from licensed operations that occurred from the late 1950s until 1967.

The NRC will require the licensee to remediate the Quehanna Site to meet the NRC's decommissioning criteria and, during decommissioning activities, to maintain effluents and doses within NRC requirements and as low as reasonably achievable.

Prior to approving the decommissioning plan, the NRC will have made findings required by the Atomic Energy Act of 1954, as amended, and NRC's regulations. Renewal of the license, including approval of the Decommissioning Plan for the Quehanna Site, will be documented in an amendment to License No. 37–17860–02.

II. Opportunity To Provide Comments

In accordance with 10 CFR 20.1405, the NRC is providing notice to individuals in the vicinity of the site that the NRC is in receipt of a DP, and will accept comments concerning this decommissioning proposal and its associated environmental impacts. Comments with respect to this action should be provided in writing within 30 days of this notice and addressed to James Kottan, Project Manager, Decommissioning and Laboratory Branch, Division of Nuclear Materials Safety, Region I, 475 Allendale Road, King of Prussia, PA 19406. Telephone: (610) 337–5214, fax number (610) 337–5269, and/or e-mail *jjk@nrc.gov.* Comments received after 30 days will be considered if practicable to do so, but only those comments received on or before the due date can be assured consideration.

III. Opportunity To Request a Hearing

NRC also provides notice that this is a proceeding on an application for an amendment of a license falling within the scope of Subpart L, ''Informal Hearing Procedures for Adjudication in Materials Licensing Proceedings,'' of NRC's rules and practice for domestic licensing proceedings in 10 CFR part 2. Whether or not a person has or intends to provide comments as set out in section II. above, pursuant to § 2.1205(a), any person whose interest may be affected by this proceeding may file a request for a hearing in accordance with § 2.1205(d). A request for a hearing must be filed within thirty (30) days of the date of publication of this **Federal Register** notice.

The request for a hearing must be filed with the Office of the Secretary either:

1. By delivery to Secretary, U.S. Nuclear Regulatory Commission, One White Flint North, 11555 Rockville Pike, Rockville, MD 20852–2738, between 7:45 a.m. and 4:15 p.m., Federal workdays; or

2. By mail, telegram, or facsimile addressed to the Secretary, U.S. Nuclear Regulatory Commission, Washington, DC 20555–0001. Attention: Rulemakings and Adjudications Staff. Because of continuing disruptions in the delivery of mail to United States Government offices, it is requested that requests for hearing also be transmitted to the Secretary of the Commission either by means of facsimile transmission to 301–415–1101, or by e-mail to *hearingdocket@nrc.gov*.

In accordance with 10 CFR 2.1205(f), each request for a hearing must also be served, by delivering it personally or by mail, to:

1. The applicant, Pennsylvania Department of Environmental Protection, Bureau of Radiation Protection, Rachel Carson State Office Building, P.O. Box 2063, Harrisburg, Pennsylvania 17105–2063, Attention: David J. Allard, Bureau Director; and

2. The NRC staff, by delivery to the General Counsel, U.S. Nuclear Regulatory Commission, One White Flint North, 11555 Rockville Pike, Rockville, MD 20852–2738, between 7:45 am and 4:15 p.m., Federal workdays, or by mail, addressed to the General Counsel, U.S. Nuclear Regulatory Commission, Washington, DC 20555–0001. Because of continuing disruptions in the delivery of mail to United States Government offices, it is requested that requests for hearing be also transmitted to the Office of the General Counsel, either by means of facsimile transmission to (301) 415–3725, or by e-mail to *OGCMailCenter@nrc.gov.*

In addition to meeting other applicable requirements of 10 CFR part 2 of NRC's regulations, a request for a hearing filed by a person other than an applicant must describe in detail:

1. The interest of the requester in the proceeding;

2. How that interest may be affected by the results of the proceeding, including the reasons why the requester should be permitted a hearing, with particular reference to the factors set out in § 2.1205(h);

3. The requester's areas of concern about the licensing activity that is the subject matter of the proceeding; and

4. The circumstances establishing that the request for a hearing is timely in accordance with § 2.1205(d).

IV. Further Information

Additional details with respect to this action, the renewal application, including the decommissioning plan, are available for inspection at the NRC's Public Electronic Reading Room at *http://www.nrc.gov/NRC/ADAMS/index.html.* [Accession Number: ML030800038]. These documents are also available for inspection and copying for a fee at the Region I Office, 475 Allendale Road, King of Prussia, Pennsylvania, 19406.

Dated at King of Prussia, Pennsylvania, this 24th day of July, 2003.

For the Nuclear Regulatory Commission.

Ronald Bellamy,

Chief, Decommissioning and Laboratory Branch, Division of Nuclear Materials Safety, RI.

[FR Doc. 03–19689 Filed 8–1–03; 8:45 am]

BILLING CODE 7590–01–P

OFFICE OF PERSONNEL MANAGEMENT

Proposed Collection; Comment Request for Review of an Information Collection: Reemployment of Annuitants, 5 CFR 837.103

AGENCY: Office of Personnel Management.

ACTION: Notice.

SUMMARY: In accordance with the Paperwork Reduction Act of 1995 (Pub. L. 104–13, May 22, 1995), this notice announces that the Office of Personnel Management (OPM) intends to submit to the Office of Management and Budget a request for review of an expiring information collection. Section 837.103 of Title 5, Code of Federal Regulations, requires agencies to collect information from retirees who become employed in Government positions. Agencies need to collect timely information regarding the type and amount of annuity being received so the correct rate of pay can be determined. Agencies provide this information to OPM so a determination can be made whether the reemployed retiree's annuity must be terminated.

Comments are particularly invited on: Whether this collection of information is necessary for the proper performance of functions of the Office of Personnel Management, and whether it will have practical utility; whether our estimate of the public burden of this collection of information is accurate, and based on valid assumptions and methodology; and ways in which we can minimize the burden of the collection of information on those who are to respond, through the use of appropriate technological collection techniques or other forms of information technology.

We estimate 3,000 reemployed retirees are asked this information annually. It takes each reemployed retiree approximately 5 minutes to provide the information for an annual estimated burden of 250 hours.

For copies of this proposal, contact Mary Beth Smith-Toomey on (202) 606–8358, FAX (202) 418–3251 or via e-mail to *mbtoomey@opm.gov.* Please include a mailing address with your request.

DATES: Comments on this proposal should be received within 60 calendar days from the date of this publication.

ADDRESSES: Send or deliver comments to—Ronald W. Melton, Chief, Operations Support Group, Center for Retirement and Insurance Services, U.S. Office of Personnel Management, 1900 E Street, NW., Room 3349A, Washington, DC 20415–3540.

FOR INFORMATION REGARDING ADMINISTRATIVE COORDINATION—CONTACT: Cyrus S. Benson, Team Leader, Publications Team, Support Group, (202) 606–0623.

Office of Personnel Management.

Kay Coles James,

Director.

[FR Doc. 03–19704 Filed 8–1–03; 8:45 am]

BILLING CODE 6325–50–P

OFFICE OF PERSONNEL MANAGEMENT

Proposed Collection; Comment Request for Review of an Expiring Information Collection: Declaration for Federal Employment Optional Form 306

AGENCY: Office of Personnel Management.

ACTION: Notice.

SUMMARY: In accordance with the Paperwork Reduction Act of 1995 (Pub. L. 104–13), this notice announces that the Office of Personnel Management intends to submit to the Office of Management and Budget a request for clearance of an expiring information collection. The OF 306 is completed by applicants who are under serious consideration for employment. It is completed early enough in the employment process that if an agency encounters an applicant who did not register with the Selective Service, the agency would have sufficient time to determine if non-registration was done knowingly and willfully prior to making a final employment decision.

Comments are particularly invited on:

• Whether this collection of information is necessary for the proper performance of functions of the Office of Personnel Management.

• Whether our estimate of the public burden of this collection is accurate, and based on valid assumptions and methodology; and

• Ways in which we can minimize the burden of the collection of information on those who are to respond, through use of the appropriate technological collection techniques or other forms of information technology.

It is estimated that 474,000 individuals will respond annually. Each form takes approximately 15 minutes to complete. The annual estimated burden is 118,500 hours.

For copies of this proposal, contact Mary Beth Smith-Toomey on (202) 606–8358, Fax (202) 418–3251 or e-mail to *mbtoomey@opm.gov*. Please be sure to include a mailing address with your request.

DATES: Comments on this proposal should be received within 60 calendar days from the date of this publication.

ADDRESSES: Send or deliver comments to: Kathy L. Dillaman, Deputy Associate Director, Center for Investigations Services, U.S. Office of Personnel Management, 1900 E Street, NW., Room 5416, Washington, DC 20415.

FOR INFORMATION REGARDING ADMINISTRATIVE COORDINATION CONTACT: Sherry G. Tate, Program Analyst, Program Services Group, Center for Investigations Services, (202) 606–0434.

Office of Personnel Management

Kay Coles James,

Director.

[FR Doc. 03–19705 Filed 8–1–03; 8:45 am]

BILLING CODE 6325–40–P

SECURITIES AND EXCHANGE COMMISSION

Proposed Collection; Comment Request

Upon Written Request, Copies Available From: Securities and Exchange Commission, Office of Filings and Information Services, Washington, DC 20549.

Extension

Form T–6, OMB Control No. 3235–0391, SEC File No. 270–344
Form 11–K, OMB Control No. 3235–0082, SEC File No. 270–101
Form 144, OMB Control No. 3235–0101, SEC File No. 270–112

Notice is hereby given that pursuant to the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 *et seq.*) the Securities and Exchange Commission (''Commission'') is soliciting comments on the collections of information summarized below. The Commission plans to submit these existing collections of information to the Office of Management Budget for extension and approval.

Form T–6 (OMB Control No. 3235–0391, SEC File No. 270–344) is a statement of eligibility and qualification for a foreign corporate trustee under the Trust Indenture Act of 1939. Form T–6 provides the basis for determining if a trustee is qualified. Form T–6 takes approximately 17 burden hours to be prepared and is filed by 15 respondents. It is estimated that 25% of the 255 total burden hours (64 hours) is prepared by the filer. The remaining 75% of burden hours is prepared by outside counsel.

Form 11–K (OMB Control No. 3235–0082; SEC File No. 270–101) is the annual report designed for use by employee stock purchase, savings and similar plans to facilitate their compliance with the reporting requirement. The Form 11–K is necessary to provide employees with information, including financial information, with respect to the investment vehicle or plan itself. Also, Form 11–K provides employees with the necessary information to assess the performance of the investment vehicle in which their money is invested. Form 11–K takes approximately 30 burden hours to prepare and is filed by 2,300 respondents for total of 69,000 burden hours.

Form 144 (OMB 3235–0101; SEC File No. 270–112) is used to report the sale of securities during any three-month period that exceeds 500 shares or other units or has an aggregate sales price in excess of $10,000. Form 144 operates in conjunction with Rule 144. Form 144 takes approximately 2 burden hours to prepare and is filed by 18,096 respondents for a total of 36,192 total burden hours.

Written comments are invited on: (a) Whether these proposed collections of information are necessary for the proper performance of the functions of the agency, including whether the information will have practical utility; (b) the accuracy of the agency's estimate of the burden of the collection of information collection information; (c) ways to enhance the quality, utility, and clarity of the information collected; and (d) ways to minimize the burden of the collection of information on respondents, including through the use of automated collection techniques or other forms of information technology. Consideration will be given to comments and suggestions submitted in writing within 60 days of this publication.

Please direct your written comments to Kenneth A. Fogash, Acting Associate Executive Director/CIO, Office of Information Technology, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549.

Dated: July 25, 2003.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 03–19725 Filed 8–1–03; 8:45 am]

BILLING CODE 8010–01–P

SECURITIES AND EXCHANGE COMMISSION

Submission for OMB Review; Comment Request

Upon Written Request, Copies Available From: Securities and Exchange Commission, Office of Filings and Information Services, 450 5th Street, NW., Washington, DC 20549.

Extension:

Rule 44, SEC File No. 270–162, OMB Control No. 3235–0147.

Notice is hereby given that, pursuant to the Paperwork Reduction Act of 1995 (44 U.S.C. 3501, *et seq.*), the Securities and Exchange Commission (''Commission'') is soliciting comments on the collection of information summarized below. The Commission plans to submit this existing collection of information to the Office of Management and Budget for extension and approval.

Rule 44, (17 CFR 250.44) under the Public Utility Holding Company Act of 1935, as amended (''Act''), 15 U.S.C. 79, *et seq.,* prohibits sales of utility assets and utility securities owned by public utility holding companies registered under the Act, except pursuant to a declaration filed with, and approved by, the Commission.

The Commission estimates that the total annual reporting burden of Rule 44 is 96 hours (4 responses $\times$ 24 hours = 96 hours).

The estimate of average burden hours is made for purposes of the Paperwork Reduction Act and is not derived from a comprehensive or representative survey or study of the costs of complying with the requirements of Commission rules and forms.

Written comments are invited on: (1) 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; (2) the accuracy of the agency's estimate of the burden of the collection of information; (3) ways to enhance the quality, utility and clarity of the information collected; and (4) ways to minimize the burden of the collection of information on respondents, including through the use of automated collection techniques or other forms of information technology. Consideration will be given to comments and suggestions submitted in writing within 60 days of this publication.

Please direct your written comments to Kenneth A. Fogash, Acting Associate Executive Director/CIO, Office of Information Technology, Securities and Exchange Commission, 450 5th Street, NW., Washington, DC 20549.

Dated: July 24, 2003.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 03–19726 Filed 8–1–03; 8:45 am]

BILLING CODE 8010–01–P

SECURITIES AND EXCHANGE COMMISSION

Submission for OMB Review; Comment Request

Upon Written Request, Copies Available From: Securities and Exchange Commission, Office of Filings and Information Services, Washington, DC 20549.

Extension:

Rule 17g–1 [17 CFR 270.17g–1], SEC File No. 270–208, OMB Control No. 3235–0213.

Notice is hereby given that, pursuant to the Paperwork Reduction Act of 1995 (44 U.S.C. 3501–3520), the Securities and Exchange Commission (the ''Commission'') has submitted to the Office of Management and Budget (''OMB'') a request for extension of approval of the previously approved collection of information discussed below.

Rule 17g–1 governs the fidelity bonding of officers and employees of registered management investment companies (''funds'') and their advisers. Rule 17g–1 requires, in part, the following:

- *Independent Directors' Approval Requirements.* At least annually, the independent directors of a fund must approve the form and amount of the fund's fidelity bond. Rule 17g–1 provides a schedule of minimum amounts for fidelity bonds based on a fund's size. The independent directors also must approve the amount of any premium paid for any ''joint bond'' covering multiple funds or certain other affiliates of the fund.
- *Fidelity Bond Content Requirements.* The fidelity bond must provide that it shall not be cancelled, terminated or modified except upon 60-days written notice to the affected party and to the Commission. In the case of a joint bond, this 60-day notice also must be given to each fund and to the Commission. In addition, a joint bond must provide that the fidelity insurance company will provide all funds covered by the bond with (i) a copy of the bond and any amendments to the bond; (ii) a copy of any formal filing of a claim on the bond; and (iii) notification of the terms of the settlement on any claim prior to execution of that settlement.
- *Joint Bond Agreement Requirement.* A fund that is insured by a joint bond must enter into an agreement with all other parties insured by the joint bond regarding recovery under the joint bond.
- *Required Filings with the Commission.* Upon execution of a fidelity bond or any amendment thereto, a fund must file with the Commission a copy of: (i) The executed fidelity bond; (ii) the resolution of the fund's independent directors approving the fidelity bond; and (iii) a statement as to the period for which the fidelity bond premiums have been paid. In the case of a joint bond, a fund also must file a copy of: (i) A statement showing the amount of a single insured bond the fund would have maintained under the rule had it not been named under a joint bond; and (ii) each agreement between the fund and all other insured parties. A fund also must notify the Commission in writing within 5 days of any claim and settlement on a claim made under a fidelity bond.
- *Required Notices to Directors.* A fund must notify by registered mail each member of its board of directors of (i) any cancellation, termination or modification of the fidelity bond at least 45 days prior to the effective date; and (ii) the filing or settlement of any claim under the fidelity bond when the notification is filed with the Commission. Rule 17g–1's independent directors' annual review requirements, fidelity bond content requirements, joint bond agreement requirement and the required notices to directors are designed to ensure the safety of fund assets against losses due to the conduct of persons who may obtain access to those assets. These requirements also facilitate oversight of a fund's fidelity bond. The rule's required filings with the Commission are designed to assist the Commission in monitoring funds' compliance with the fidelity bond requirements.

The Commission staff estimates that approximately 4600 funds are subject to the requirements of rule 17g–1, and that on average a fund spends approximately one hour per year complying with the rule's paperwork requirements. The Commission staff therefore estimates the total annual burden of the rule's paperwork requirements to be 4600 hours.

These estimates of average burden hours are made solely for the purposes of the Paperwork Reduction Act. These estimates are not derived from a comprehensive or even a representative survey or study of Commission rules. The collection of information required by rule 17g–1 is mandatory and will not be kept confidential. 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.

Please direct general comments regarding the information above to: (i) Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Office of Management and Budget, Room 10102, New Executive Office Building, Washington, DC 20503; and (ii) Kenneth A. Fogash, Acting Associate Executive Director/CIO, Office of Information Technology, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549. Comments must be submitted to OMB within 30 days of this notice.

Dated: July 22, 2003.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 03–19727 Filed 8–1–03; 8:45 am]

BILLING CODE 8010–01–P

SECURITIES AND EXCHANGE COMMISSION

Proposed Collection; Comment Request

Upon Written Request, Copies Available From: Securities and Exchange Commission, Office of Filings and

Information Services, Washington, DC 20549.

Extension:

Rule 6c–7; SEC File No. 270–269; OMB Control No. 3235–0276.

Notice is hereby given that pursuant to the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 *et seq.*), the Securities and Exchange Commission (''Commission'') is soliciting comments on the collection of information summarized below. The Commission plans to submit this existing collection of information to the Office of Management and Budget for extension and approval.

Rule 6c–7 [17 CFR 270.6c–7] under the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*) (''1940 Act'') provides exemption from certain provisions of Sections 22(e) and 27 of the 1940 Act for registered separate accounts offering variable annuity contracts to certain employees of Texas institutions of higher education participating in the Texas Optional Retirement Program. There are approximately 80 registrants governed by Rule 6c–7. The burden of compliance with Rule 6c–7, in connection with the registrants obtaining from a purchaser, prior to or at the time of purchase, a signed document acknowledging the restrictions on redeemability imposed by Texas law, is estimated to be approximately 3 minutes of professional time per response for each of 2600 purchasers annually (at an estimated $70 per hour), for a total annual burden of 130 hours (at a total annual cost of $9,100).

The estimate of average burden hours is made solely for the purposes of the Paperwork Reduction Act, and is not derived from a comprehensive or even a representative survey or study of the costs of Commission rules or forms. The Commission does not include in the estimate of average burden hours the time preparing registration statements and sales literature disclosure regarding the restrictions on redeemability imposed by Texas law. The estimate of burden hours for completing the relevant registration statements are reported on the separate PRA submissions for those statements. (*See* the separate PRA submissions for Form N–3 [17 CFR 274.11b] and Form N–4 [17 CFR 274.11c].)

Complying with the collection of information requirements of the rules is necessary to obtain a benefit. 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.

Written comments are invited on: (a) 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; (b) the accuracy of the agency's estimate of the burden of the collection of information; (c) ways to enhance the quality, utility, and clarity of the information collected; and (d) ways to minimize the burden of the collection of information on respondents, including through the use of automated collection techniques or other forms of information technology. Consideration will be given to comments and suggestions submitted in writing within 60 days of this publication.

Please direct your written comments to Kenneth A. Fogash, Acting Associate Executive Director/CIO, Office of Information Technology, Securities and Exchange Commission, 450 5th Street NW., Washington, DC 20549.

Dated: July 21, 2003.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 03–19728 Filed 8–1–03; 8:45 am]

BILLING CODE 8010–01–P

SECURITIES AND EXCHANGE COMMISSION

Proposed Collection; Comment Request

Upon Written Request, Copies Available From: Securities and Exchange Commission, Office of Filings and Information Services, Washington, DC 20549.

Extension:

Rule 11a–2; SEC File No. 270–267; OMB Control No. 3235–0272.

Notice is hereby given that pursuant to the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 *et seq.*) the Securities and Exchange Commission (''Commission'') is soliciting comments on the collection of information summarized below. The Commission plans to submit to the Office of Management and Budget a request for an extension of the previously approved collection of information discussed below.

The title for the collection of information is ''Rule 11a–2 Under the Investment Company Act of 1940: Offers of Exchange by Certain Registered Separate Accounts or Others the Terms of Which Do Not Require Prior Commission Approval.''

Rule 11a–2 [17 CFR 270.11a–2] permits certain registered insurance company separate accounts, subject to certain conditions, to make exchange offers without prior approval by the Commission of the terms of those offers. Rule 11a–2 requires disclosure, in certain registration statements filed pursuant to the 1933 Act, of any administrative fee or sales load imposed in connection with an exchange offer.

There are currently 711 registrants governed by Rule 11a–2. The Commission includes the estimated burden of complying with the information collection required by Rule 11a–2 in the total number of burden hours estimated for completing the relevant registration statements and reports the burden of Rule 11a–2 in the separate PRA submissions for those registration statements (see the separate PRA submissions for Form N–3 [17 CFR 274.11b], Form N–4 [17 CFR 274.11c] and Form N–6 [17 CFR 274.11d]). The Commission is requesting a burden of one hour for Rule 11a–2 for administrative purposes.

The estimate of average burden hours is made solely for the purposes of the Paperwork Reduction Act, and is not derived from a comprehensive or even a representative survey or study of the costs of Commission rules or forms. With regard to Rule 11a–2, the Commission includes the estimate of burden hours in the total number of burden hours estimated for completing the relevant registration statements and reported on the separate PRA submissions for those statements (*see* the separate PRA submissions for Form N–3, Form N–4 and Form N–6).

The information collection requirements imposed by Rule 11a–2 are mandatory. Responses to the collection of information will not be kept confidential. 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.

Written comments are invited on: (a) Whether the collection of information is necessary for the proper performance of the functions of the Commission, including whether the information has practical utility; (b) the accuracy of the Commission's estimate of the burden of the collection of information; (c) ways to enhance the quality, utility, and clarity of the information collected; and (d) ways to minimize the burden of the collection of information on respondents, including through the use of automated collection techniques or other forms of information technology. Consideration will be given to comments and suggestions submitted in writing within 60 days of this publication.

Please direct your written comments to Kenneth A. Fogash, Acting Associate

Executive Director/CIO, Office of Information Technology, Securities and Exchange Commission, 450 5th Street, NW., Washington, DC 20549.

Dated: July 24, 2003.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 03–19729 Filed 8–1–03; 8:45 am]

BILLING CODE 8010–01–P

SECURITIES AND EXCHANGE COMMISSION

Issuer Delisting; Notice of Application To Withdraw From Listing and Registration on the Pacific Exchange, Inc. (Detwiler, Mitchell & Co., Common Stock, $.01 Par Value); File No. 1–10331

July 29, 2003.

Detwiler, Mitchell & Co., a Delaware corporation (''Issuer''), has filed an application with the Securities and Exchange Commission (''Commission''), pursuant to Section 12(d) of the Securities Exchange Act of 1934 (''Act'') [1] and Rule 12d2–2(d) thereunder,[2] to withdraw its Common Stock, $.01 par value (''Security''), from listing and registration on the Pacific Exchange, Inc. (''PCX'' or ''Exchange'').

The Board of Directors (''Board'') of the Issuer approved resolutions on July 1, 2003 to withdraw its Security from listing on the Exchange. The Board states that the reasons it decided to delist the Security from the PCX are: (i) The Issuer has approximately 221 record holders of its Security making it eligible for deregistration under Section 12(g) of the Act; (ii) the Issuer estimated the potential cost savings from deregistration and delisting from the Nasdaq SmallCap Market and the PCX to be in the range of $125,000 to $200,000 annually; (iii) the Issuer would be relieved from the time-consuming burdens of compliance with the reporting and other requirements of the Act, which have become more burdensome because of the enactment of the Sarbanes-Oxley Act of 2002; relief from these burdens would represent a substantial benefit to the business and operations of the Issuer, which cannot be quantified in monetary terms and is not reflected in estimates of cash cost savings; (iv) the reactions of stockholders, employees and clients to the prospect of deregistration and delisting were almost universally favorable, and stockholders seem to be impressed by the potential for cost savings while understanding that the Issuer's Security will continue to be publicly traded on Pink Sheets LLC's quotations service (''pink sheets''); (v) the desultory trading market in the Security through its listing on the Nasdaq SmallCap market and PCX was no more beneficial to the stockholders, and does not provide them a better trading market, than would be available to them if the Security were deregistered and traded in the ''pink sheets'' market place; the Security trades less than 10,000 shares annually on the PCX; and (vi) the Issuer could continue to provide quarterly and (audited) annual financial statements and press releases to its stockholders containing substantially the same information about the financial condition and results of operations of the Issuer as have been provided to them in the past, and will continue to provide stockholders with reports of current developments as in the past so that registration will not substantially reduce the flow of useful information to the stockholders. The Issuer states that its Security has traded over-the-counter and has been quoted in the pink sheets since July 7, 2003.

The Issuer stated in its application that it has complied with the rules of the PCX that govern the removal of securities from listing and registration on the Exchange. The Issuer's application relates solely to the withdrawal of the Security from listing and registration on the PCX and from registration under Section 12(b) [3] of the Act and shall not affect its obligation to be registered under Section 12(g) of the Act.[4]

Any interested person may, on or before August 18, 2003, submit by letter to the Secretary of the Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609, facts bearing upon whether the application has been made in accordance with the rules of the PCX and what terms, if any, should be imposed by the Commission for the protection of investors. The Commission, based on the information submitted to it, will issue an order granting the application after the date mentioned above, unless the Commission determines to order a hearing on the matter.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[5]

Jonathan G. Katz,

Secretary.

[FR Doc. 03–19664 Filed 8–1–03; 8:45 am]

BILLING CODE 8010–01–P

[1] 15 U.S.C. 78*l*(d).

[2] 17 CFR 240.12d2–2(d).

[3] 15 U.S.C. 78*l*(b).

[4] 15 U.S.C. 78*l*(g).

[5] 17 CFR 200.30–3(a)(1).

SECURITIES AND EXCHANGE COMMISSION

Issuer Delisting; Notice of Application To Withdraw From Listing and Registration on the American Stock Exchange LLC (Dot Hill Systems Corp., Common Stock, $.001 par value); File No. 1–13317

July 29, 2003.

Dot Hill Systems Corp., a Delaware corporation (''Issuer''), has filed an application with the Securities and Exchange Commission (''Commission''), pursuant to Section 12(d) of the Securities Exchange Act of 1934 (''Act'') [1] and Rule 12d2–2(d) thereunder,[2] to withdraw its Common Stock, $.001 par value (''Security''), from listing and registration on the American Stock Exchange LLC (''Amex'' or ''Exchange'').

The Issuer stated in its application that it has met the requirements of Amex Rule l8 by complying with all applicable laws in the State of Delaware, in which it is incorporated, and with the Amex's rules governing an issuer's voluntary withdrawal of a security from listing and registration.

The Issuer stated that it is taking such action because the Issuer believes that listing on the Nasdaq National Market will provide superior trading and visibility in the investment community, among other advantages. The Issuer also stated that this is of particular importance as the Issuer anticipates pursuing a follow-on public offering in the near future.

The Issuer's application relates solely to the withdrawal of the Securities from listing on the Amex and from registration under Section 12(b) of the Act [3] shall not affect its obligation to be registered under Section 12(g) of the Act. [4]

Any interested person may, on or before August 18, 2003, submit by letter to the Secretary of the Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609, facts bearing upon whether the application has been made in accordance with the rules of the Amex and what terms, if any, should be imposed by the Commission for the protection of investors. The Commission, based on the information submitted to it, will issue an order granting the application after the date mentioned above, unless the Commission determines to order a hearing on the matter.

[1] 15 U.S.C. 78l(d).

[2] 17 CFR 240.12d2–2(d).

[3] 15 U.S.C. 78*l*(b).

[4] 15 U.S.C. 78*l*(g).

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[5]

Jonathan G. Katz,

Secretary.

[FR Doc. 03–19665 Filed 8–1–03; 8:45 am]

BILLING CODE 8010–01–U

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–48236; File No. SR–NASD–2003–105]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. To Implement a Six-Month Pilot Program Establishing Fees for Written Interpretations of Nasdaq Listing Rules

July 28, 2003.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] and Rule 19b–4 thereunder,[2] notice is hereby given that on July 3, 2003, the National Association of Securities Dealers, Inc. (''NASD''), through its subsidiary, The Nasdaq Stock Market, Inc. (''Nasdaq''), filed with the Securities and Exchange Commission (''Commission'') the proposed rule change as described in Items I, II, and III below, which Items have been prepared by Nasdaq.[3] The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of the Substance of the Proposed Rule Change

Nasdaq proposes to implement a pilot program that establishes fees for written interpretations of Nasdaq listing rules. The text of the proposed rule change is below. Proposed new language is in *italics*.

* * * * *

4500. Issuer Listing Fees

4550. Written Interpretations of Nasdaq Listing Rules

(a) An issuer listed on The Nasdaq SmallCap Market or The Nasdaq National Market may request from Nasdaq a written interpretation of the Rules contained in the 4000 through 4500 Series. In connection with such a request, the issuer must submit to The Nasdaq Stock Market, Inc. a non-refundable fee of $2,000. A response to such a request generally will be provided within four weeks from the date Nasdaq receives all information necessary to respond to the request.

(b) Notwithstanding paragraph (a), an issuer may request a written interpretation of the Rules contained in the 4000 through 4500 Series by a specific date that is less than four weeks, but at least one week, after the date Nasdaq receives all information necessary to respond to the request. In connection with such a request for an expedited response, the issuer must submit to The Nasdaq Stock Market, Inc. a non-refundable fee of $10,000.

(c) An applicant to The Nasdaq Stock Market that has submitted the applicable entry fee under Rule 4510 or Rule 4520 will not also be required to submit a fee in connection with a request for a written interpretation involving the applicant's initial inclusion on Nasdaq. In addition, an issuer is not required to submit a fee in connection with a request for an exception from the Nasdaq shareholder approval rules pursuant to Rule 4350(i)(2).

(d) The Board of Directors of The Nasdaq Stock Market, Inc. or its designee may, in its discretion, defer or waive all or any part of the written interpretation fee prescribed herein.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, Nasdaq included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. Nasdaq has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The purpose of the proposed rule change is to institute a six-month pilot program that establishes a fee for written interpretations of Nasdaq listing rules. Nasdaq proposes that this rule change become effective on October 1, 2003 or upon Commission approval, whichever date is later. Nasdaq will monitor the effect of this rule change on the listing rules interpretative process during this period. Prior to the completion of the pilot, Nasdaq will evaluate the impact of this rule and report its findings to the Commission, and thereafter, determine the appropriate course of action.

Currently, issuers may contact Nasdaq to request an interpretation regarding the application of Nasdaq's listing rules to a particular set of facts. For example, an issuer negotiating a private placement might want to ensure that the proposed transaction does not require shareholder approval under Nasdaq's rules. Alternatively, an issuer seeking to add a new director to its board of directors may inquire as to the impact of a prior relationship with that individual on the person's independence under Nasdaq rules.

Issuers can request formal interpretative guidance of Nasdaq's listing rules by submitting a letter that identifies the issuer and provides all relevant facts and circumstances surrounding the question. Staff of Nasdaq's Listing Qualifications Department will prepare a response letter, which the Nasdaq Office of General Counsel reviews prior to issuance. Written interpretations are binding on Nasdaq unless the issuer has made a material misstatement or omission, there is a subsequent change in the facts or circumstances that the issuer described in its letter, or there is a subsequent change in Nasdaq's listing requirements.[4] Since written interpretations are based on the specific facts and circumstances presented by an issuer, an issuer may not rely on a written interpretation that has been provided to another issuer. However, to provide transparency regarding our rules and policies, Nasdaq publishes anonymous summaries of these interpretative letters on its Web site, at *http://www.nasdaq.com/about/StaffInterpLetters.stm*.

Nasdaq currently provides written interpretations at no cost to issuers. In recent years, however, there has been an increase in the complexity of transactions for which issuers have sought interpretations. As a result, Nasdaq staff now spends an increasing amount of time on routine interpretation letters, with some interpretations

[5] 17 CFR 200.30–3(a)(1).

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] The Commission revised text in the description of the proposed rule change to clarify certain terms of the pilot, and added a reference to its proposed start date, with the consent of Nasdaq. *See* e-mails from John Nachmann, Senior Attorney, Nasdaq, to Andrew Shipe, Special Counsel, and Leah Mesfin, Attorney, Division of Market Regulation, Commission, dated July 21 and July 22, 2003.

[4] Nasdaq also provides oral guidance regarding its listing rules. Issuers will often request such guidance on a ''no names'' basis, while they still are structuring a transaction or analyzing the impact of a proposed change. Since oral guidance may not be based on a complete review of all relevant facts and circumstances, it is not binding on Nasdaq.

requiring as much as 20 staff hours to complete.

In order to address, in part, the costs associated with the written interpretation process, Nasdaq is proposing to adopt a $2,000 fee for interpretation letters. Nasdaq will generally respond to such requests in the order received, and responses require approximately four weeks from the date that Nasdaq receives all information necessary to respond to the request. However, Nasdaq recognizes that, due to business exigencies or other reasons, an issuer may require an interpretation letter in a shorter period of time. In such situations, an issuer can request that an interpretation letter be processed by a specific date that is less than four weeks, but at least one week, after the date Nasdaq receives all information necessary to respond to the request. Nasdaq will make all reasonable efforts to meet the date specified by the issuer. Nasdaq is proposing to adopt a $10,000 fee for interpretation letters processed on an expedited basis.

Nasdaq will not assess fees for requests submitted by issuers with regard to initial listing on Nasdaq, because reviews of these matters are considered to be part of the processing of an issuer's application and a separate application fee is already charged in these situations. In addition, issuers will not be required to submit a fee in connection with requests for an exception from the Nasdaq shareholder approval rules pursuant to Rule 4350(i)(2), since requests for such exceptions involve issuers whose financial viability is in jeopardy. Lastly, in order to address other exceptional situations where the payment of a fee for an interpretation letter would be inequitable under the circumstances, Nasdaq is proposing to provide the Nasdaq Board of Directors or its designee the discretion to defer or waive all or any part of the written interpretation fee. Such discretion will not be used in generally applicable or frequently-replicated situations, but only in circumstances that are truly unique.[5]

2. Statutory Basis

Nasdaq believes that the proposed rule change is consistent with the provisions of Section 15A of the Act,[6] in general and with Section 15A(b)(5) of the Act,[7] in particular, in that the proposal provides for the equitable allocation of reasonable dues, fees, and other charges among members and issuers and other persons using any facility or system which the NASD operates or controls. Specifically, the proposed fees will be imposed equally on all listed issuers that request written interpretations of Nasdaq's listing rules and will relieve issuers not availing themselves of this process from subsidizing its cost.

B. Self-Regulatory Organization's Statement on Burden on Competition

Nasdaq does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

Written comments were neither solicited nor received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) As the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

A. By order approve such proposed rule change, or

B. Institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to file number SR–NASD–2003–105 should be submitted by August 25, 2003.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[8]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 03–19666 Filed 8–1–03; 8:45 am]

BILLING CODE 8010–01–P

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–48240; File No. SR–Amex–2003–67]

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the American Stock Exchange LLC To Extend the Suspension of Transaction Charges for Certain iShares Funds

July 28, 2003.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] and Rule 19b–4 thereunder,[2] notice is hereby given that on June 30, 2003, the American Stock Exchange LLC (''Amex'' or ''Exchange'') filed with the Securities and Exchange Commission (''SEC'' or ''Commission'') the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The Amex proposes to extend until July 31, 2003 the suspension of Exchange transaction charges for specialist, Registered Trader, and broker-dealer orders for the iShares Lehman 1–3 year Treasury Bond Fund and the iShares Lehman 7–10 year Treasury Bond Fund. Proposed new language is *italicized*; proposed deletions are in [brackets].

* * * * *

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[5] See letter from Annette L. Nazareth, Director, Division of Market Regulation, Commission, to T. Grant Callery, Executive Vice President and General Counsel, NASD (March 27, 2003).

[6] 15 U.S.C. 78o–3.

[7] 15 U.S.C. 78o–3(b)(5).

[8] 17 CFR 200.30–3(a)(12).

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

AMEX EQUITY FEE SCHEDULE

I. Transaction Charges

No change.

II. Regulatory Fee

No Change.

Notes:

1. and 2. No change.

3. Customer transaction charges for the following Portfolio Depositary Receipts, Index Fund Shares, and Trust Issued Receipts have been suspended:

DIA–DIAMONDS®
QQQ—Nasdaq—100® Index Tracking Stock
SPY—SPDRs®
IVV—iShares S&P 500
MDY—MidCap SPDRs
XLY—Select Sector SPDR—Consumer Discretionary
XLP—Select Sector SPDR—Consumer Staples
XLE—Select Sector SPDR—Energy
XLF—Select Sector SPDR—Financial
XLV—Select Sector SPDR—Health Care
XLI—Select Sector SPDR—Industrial
XLB—Select Sector SPDR—Materials
XLK—Select Sector SPDR—Technology
XLU—Select Sector SPDR—Utilities
BHH—B2B Internet HOLDRs™.
BBH—Biotech HOLDRs.
BDH—Broadband HOLDRs.
EKH—Europe 2001 HOLDRs.
IAH—Internet Architecture HOLDRs.
HHH+Internet HOLDRs.
IIH—Internet Infrastructure HOLDRs.
MKH—Market 2000+ HOLDRs.
OIH—Oil Service HOLDRs.
PPH—Pharmaceutical HOLDRs.
RKH—Regional Bank HOLDRs.
RTH—Retail HOLDRs.
SMH—Semiconductor HOLDRs.
SWH—Software HOLDRs.
TTH—Telecom HOLDRs.
UTH—Utilities HOLDRs.
WMH—Wireless HOLDRs.
SHY—iShares Lehman 1—3 Year Treasury Bond Fund.
IEF—iShares Lehman 7—10 Year Treasury Bond Fund.
TLT—iShares Lehman 20+ Year Treasury Bond Fund.
LQD—iShares GS $ InvesTop Corporate Bond Fund.

Customer transaction charges for the iShares S&P 100 Index Fund are $.0015 per share ($.15 per 100 shares), capped at $100 per trade.

Until [June 30] *July 31, 2003*, transaction charges also have been suspended in SHY and IEF for specialist, Registered Trader and broker dealer orders.

* * * * *

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Amex included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The Exchange is extending until July 31, 2003 the suspension of transaction charges in iShares Lehman 1–3 year Treasury Bond Fund (Symbol: SHY) and iShares Lehman 7–10 year Treasury Bond Fund (Symbol: IEF) for specialist, Registered Trader and broker-dealer orders. The Exchange previously filed a suspension of such charges until November 30, 2002,[3] December 31, 2002,[4] January 31, 2003,[5] February 28, 2003,[6] March 31, 2003,[7] April 30, 2003,[8] May 31, 2003,[9] and June 30, 2003.[10]

The Exchange believes that a suspension of fees for the SHY and IEF is appropriate to enhance the competitiveness of executions in these securities on the Amex. The Exchange will reassess the fee suspension as appropriate, and will file any modification to the fee suspension with the Commission pursuant to section 19(b)(3)(A) of the 1934 Act.[11]

2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with section 6(b) of the Act[12] in general, and furthers the objectives of section 6(b)(4)[13] in particular, in that it provides for the equitable allocation of reasonable dues, fees and other charges among its members and other persons using its facilities.

B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change will impose any burden on competition.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants or Others

The Exchange has neither solicited nor received comments on the proposed rule change.

[3] *See* Securities Exchange Act Release No. 46765 (November 1, 2002), 67 FR 68893 (November 13, 2002) (SR–Amex–2002–91).

[4] *See* Securities Exchange Act Release No. 46996 (December 13, 2002), 67 FR 78264 (December 23, 2002) (SR–Amex–2002–98).

[5] *See* Securities Exchange Act Release No. 47141 (January 8, 2003), 68 FR 2090 (January 15, 2003) (SR–Amex–2002–115).

[6] *See* Securities Exchange Act Release No. 47361 (February 13, 2003), 68 FR 8534 (February 21, 2003) (SR–Amex–2003–04).

[7] *See* Securities Exchange Act Release No. 47455 (March 6, 2003), 68 FR 12111 (March 13, 2003) (SR–Amex–2003–15).

[8] *See* Securities Exchange Act Release No. 47668 (April 11, 2003), 68 FR 19241 (April 18, 2003) (SR–Amex–2003–22).

[9] *See* Securities Exchange Act Release No. 47858 (May 14, 2003), 68 FR 27872 (May 21, 2003) (SR–Amex–2003–40).

[10] *See* Securities Exchange Act Release No. 47974 (June 4, 2003), 68 FR 35030 (June 11, 2003) (SR–Amex–2003–57).

[11] 15 U.S.C. 78s(b)(3)(A).

[12] 15 U.S.C. 78f(b).

[13] 15 U.S.C. 78f(b)(4).

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The foregoing rule change has become effective pursuant to section 19(b)(3)(A) of the Act and Rule 19b–4(f)(6)[14] thereunder because the proposal: (i) Does not significantly affect the protection of investors or the public interest; (ii) does not impose any significant burden on competition; and (iii) does not become operative prior to 30 days after the date of filing or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest; provided that the Exchange has given the Commission notice of its intent to file the proposed rule change, along with a brief description and text of the proposed rule change, at least five business days prior to the date of filing of the proposed rule change, or such shorter time as designated by the Commission. At any time within 60 days of the filing of such proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors or otherwise in furtherance of the purposes of the Act.

The Amex has requested that the Commission waive the five-day pre-filing notice and the 30-day operative delay. The Commission believes that waiving the five-day pre-filing notice and the 30-day operative delay is consistent with the protection of investors and the public interest. The Commission notes that fee suspensions for the exchange-traded funds that are the subject of this filing have been previously filed with the Commission.[15] Further, extension of the fee suspension for specialist, Registered Trader, and broker-dealer orders will permit the fee suspensions to continue uninterrupted. For these reasons, the Commission designates the proposal to be effective and operative upon filing with the Commission.[16]

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying at the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the Exchange. All submissions should refer to File No. SR–Amex–2003–57 and should be submitted by August 25, 2003.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[17]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 03–19661 Filed 8–1–03; 8:45 am]

BILLING CODE 8010–01–P

[14] 17 CFR 240.19b–4(f)(6).

[15] *See supra* notes 3–10.

[16] For purposes only of accelerating the operative date of this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

[17] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–48243; File No. SR–Amex–2003–68]

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the American Stock Exchange LLC To Remove the Six-Month Limitation on the Waiver of Transaction Fees Related to Nasdaq UTP Securities and To Expand the Cap on the Amount of Transaction Fees To Cover All Transactions Related to Nasdaq UTP Securities

July 29, 2003.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] and Rule 19b–4 thereunder,[2] notice is hereby given that on July 16, 2003, the American Stock Exchange LLC (''Amex'' or ''Exchange'') filed with the Securities and Exchange Commission (''Commission'') the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. The Amex has designated this proposal as one establishing or changing a due, fee, or other charge imposed by the Exchange under section 19(b)(3)(A)(ii) of the Act,[3] and Rule 19b–4(f)(2)[4] thereunder which renders the proposal effective upon filing with the Commission. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The Amex proposes to remove the six-month limitation on the waiver of transaction fees related to Nasdaq securities admitted to dealings on an unlisted trading privileges basis (''Nasdaq UTP securities''), and to expand the scope of the cap on the dollar amount of transaction fees to cover all transactions related to Nasdaq UTP securities, and not solely cross trades. The text of the proposed rule change is available at the Amex and at the Commission.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Exchange included statements concerning the purpose of and basis for its proposal and discussed any comments it received regarding the proposal. The text of these statements may be examined at the places specified in Item IV below. The Amex has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The Amex proposes to implement two changes to its transaction fees for Nasdaq UTP securities. First, the Amex proposes to eliminate the six-month limitation on the waiver of transaction fees for specialist principal trades by specialist firms that do not charge any commission to customers in Nasdaq UTP securities. Second, the Amex proposes to expand the scope of the cap on the dollar amount of transaction fees to cover all transactions related to Nasdaq UTP securities. Currently, the cap of $50 per side per trade only applies to cross trades. The Amex notes that the proposed fee changes are intended to reduce the cost of executing transactions on the Amex.

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] 15 U.S.C. 78s(b)(3)(A)(ii).

[4] 17 CFR 240.19b–4(f)(2).

2. Statutory Basis

The Exchange believes that the proposal is consistent with section 6(b) of the Act[5] in general and furthers the objectives of section 6(b)(4) of the Act[6] in particular in that it is designed to provide for the equitable allocation of reasonable dues, fees, and other charges among Amex members and issuers and other persons using the Amex's facilities.

B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

No written comments were solicited or received with respect to the proposed rule change.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The proposed rule change has become effective pursuant to section 19(b)(3)(A)(ii) of the Act[7] and subparagraph (f)(2) of Rule 19b-4 thereunder,[8] because it establishes or changes a due, fee, or other charge imposed by the Amex. At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposal is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the Amex. All submissions should refer to file number SR–Amex–2003–68 and should be submitted by August 25, 2003.

[5] 15 U.S.C. 78f(b).

[6] 15 U.S.C. 78f(b)(4).

[7] 15 U.S.C. 78s(b)(3)(A)(ii).

[8] 17 CFR 240.19b–4(f)(2).

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[9]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 03–19662 Filed 8–1–03; 8:45 am]

BILLING CODE 8010–01–P

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–48237; File No. SR–CBOE–2003–08]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Chicago Board Options Exchange, Incorporated To Establish a Limited Pilot Program Relating to Maximum Bid/Ask Differentials

July 28, 2003.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'' or ''Exchange Act'')[1] and Rule 19b–4 thereunder,[2] notice is hereby given that on February 27, 2003, the Chicago Board Options Exchange, Incorporated (''CBOE'' or ''Exchange'') filed with the Securities and Exchange Commission (''Commission'' or ''SEC'') the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the CBOE. On July 25, 2003, the Exchange submitted Amendment No. 1 to the proposed rule change.[3] The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The CBOE proposes to amend its rules to adopt a limited pilot program relating to maximum bid/ask differentials. The text of the proposed rule change is available at the Office of the Secretary, CBOE and at the Commission.

[9] 17 CFR 200.30–3(a)(12).

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] *See* letter from Angelo Evangelou, Senior Attorney, Legal Division, CBOE, to Jennifer Colihan, Special Counsel, Division of Market Regulation, Commission, dated July 25, 2003 (''Amendment No. 1''). In Amendment No. 1, the Exchange revised the proposed rule text to indicate that the pilot program would expire on January 30, 2004.

II. Self-Regulatory Organization's Statement of the Purpose of and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, CBOE included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The CBOE has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

Background

The Exchange is proposing to adopt, on a pilot basis, a limited exemption to the Market-Maker bid/ask differential requirements contained in CBOE Rule 8.7(b)(iv). More specifically, as part of accommodating compliance with the Plan for the Purpose of Creating and Operating an Intermarket Options Linkage (the ''Linkage Plan''),[4] the Exchange is introducing a new ''autofade'' functionality which will cause one side of CBOE's disseminated quote to move to an inferior price when the quote is required to fade pursuant to the terms of the Linkage Plan and/or when the size associated with the quote has been depleted by automatic executions (of both Linkage orders and non-Linkage orders).

Linkage orders are generally Immediate or Cancel limit orders priced at the National Best Bid or Offer (''NBBO'') that must be acted upon within 15 seconds. The Linkage Plan provides several instances in which a Participant receiving a linkage order must fade its quote. For example, if a Participant receives a Principal Acting as Agent (''PA'') order for a size greater than the Firm Customer Quote Size and does not execute the entirety of the PA Order within 15 seconds, the Participant is required to fade its quote. CBOE's autofade functionality will automate the fading process to ensure that members (and the Exchange) are in full compliance with this aspect of the

[4] The Linkage Plan was originally approved on July 28, 2000. See Securities Exchange Act Release No. 43086, 65 FR 48023 (August 4, 2000).

Linkage Plan. Autofade will move one side of CBOE's quote to a price that is 1-tick inferior to the NBBO.[5] This will ensure that the Exchange will not immediately receive additional linkage orders in order to allow the member to refresh the quote (either manually or through an autoquote update).

As mentioned above, autofade also would apply anytime an automatic execution of any order via the Exchange's Retail Automatic Execution System (''RAES'') has depleted the size of CBOE's quote. On March 29, 2002, the Commission approved a CBOE proposal to implement a ''quotes with size'' system that would enable the Exchange to disseminate options quotations with a size that reflects previous executions (decrementing quotes).[6] A current feature of this functionality provides that when a quote is exhausted via automatic executions, the Exchange may disseminate a size of ''1'' for a specified ''reroute'' period during which time the Exchange's RAES system is disengaged.[7] Autofade would eliminate any need to disengage the RAES system and disseminate a size of 1 contract at the same price. Once a quote is exhausted, autofade would move one side of the quote to a price that is one tick inferior to the NBBO (as described above).

The Reason for this Rule Filing

CBOE anticipates that there may be limited instances where the autofade functionality moves the quote in a manner that causes the quote width to widen beyond the bid/ask parameters provided pursuant to CBOE Rule 8.7(b)(iv). Accordingly, CBOE seeks to adopt (on a pilot basis) a temporary exception to the requirements of CBOE Rule 8.7(b)(iv) in cases where the Exchange automatically adjusts one side of the disseminated quote to one minimum increment below (above) the NBBO bid (offer) and this cause the quote to exceed the quote width parameters of that rule. The proposed exemption period would last for 30 seconds after any given autofade that caused a wider quote than allowed under CBOE Rule 8.7(b)(iv). Thus, to the extent a quote remained outside of the maximum width after the 30-second time period, the responsible broker or dealer disseminating the quote would be deemed in violation of CBOE Rule 8.7(b)(iv) for regulatory purposes. CBOE proposes that the pilot run until January 30, 2004.

2. Statutory Basis

The proposed rule change will, among other things, allow the Exchange to comply more easily with the requirements of the Linkage Plan. Accordingly, the Exchange believes the proposed rule change is consistent with Section 6(b) of the Act [8] in general and furthers the objectives of Section 6(b)(5) [9] in particular in that it should promote just and equitable principles of trade, serve to remove impediments to and perfect the mechanism of a free and open market and a national market system, and protect investors and the public interest.

B. Self-Regulatory Organization's Statement on Burden on Competition

This proposed rule change does not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants or Others

No written comments were solicited or received with respect to the proposed rule change.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) As the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) By order approve such proposed rule change, or

(B) Institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549–0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section. Copies of such filing will also be available for inspection and copying at the principal office of CBOE. All submissions should refer to File No. SR–CBOE–2003–08 and should be submitted by August 25, 2003.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[10]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 03–19663 Filed 8–1–03; 8:45 am]

BILLING CODE 8010–01–P

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–48234; File No. SR–NASD–2003–93]

Self-Regulatory Organizations; Order Granting Approval of Proposed Rule Change by the National Association of Securities Dealers, Inc., To Increase the Trading Activity Fee

July 28, 2003.

I. Introduction

On June 11, 2003, the National Association of Securities Dealers, Inc. (''NASD'') filed with the Securities and Exchange Commission (''SEC'' or ''Commission''), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'') [1] and Rule 19b–4 thereunder,[2] a proposed rule change to increase its Trading Activity Fee (''TAF'') by adjusting the rates for covered equity securities. The proposed rule change was published for notice and comment in the **Federal Register** on June 25, 2003.[3] The Commission received one comment letter on the proposal.[4] On July 23, 2003, the NASD

[5] The only exception is when CBOE's NBBO quote (or next best quote) is represented by a customer order in the book. In such cases, the Exchange would not fade a booked order (it would have to be traded).

[6] See Securities Exchange Act Release No. 45676, 67 FR 16478 (April 5, 2002).

[7] The reroute period can be set from 0 to 30 seconds.

[8] 15 U.S.C. 78f(b).

[9] 15 U.S.C. 78f(b)(5).

[10] 17 CFR 200.30–3(a)(12).

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] *See* Securities Exchange Act Release No. 48061 (June 19, 2003), 68 FR 37887.

[4] *See* July 17, 2003 letter from Jeffrey T. Brown, Senior Vice President and General Counsel, The Cincinnati Stock Exchange (''CSE'') to Jonathan G. Katz, Secretary, SEC (''CSE Letter'').

filed its response to comments.[5] This order approves the proposed rule change.

II. Summary of Comments

The Commission received one comment letter on the NASD's proposal to increase the TAF.[6]

- *The CSE Letter*

The CSE disapproved of the proposed rule change, stating the proposal would ''double the ill-defined TAF with no justification'' and with ''little check or recourse on the part of the non-NASD markets.'' [7] The CSE suggested that the Commission require the NASD to provide supporting documentation to explain the need for increasing the TAF before allowing the NASD to double the fee.[8] Additionally, the CSE stated that the NASD must delineate its responsibilities covered by the TAF, explain how those responsibilities are unique to the NASD, and provide a cost analysis that establishes a nexus between those responsibilities and the fees.[9]

The CSE also stated that the TAF, along with the NASD's Gross Income Assessment, allows ''for the subsidization of NASD regulatory activities through the forced taxing of transactions occurring on other markets.'' [10] According to the CSE, the NASD is using the TAF and Gross Income Assessment, under the guise of revenue neutrality, to subsidize its regulatory activities with monies generated on other markets.[11]

The CSE asked for an accounting, and an explanation of why the NASD believes it is proper to limit this fee adjustment to the TAF, when the TAF is only one component of a fee structure that also includes the Gross Income Assessment (''GIA'') and the Personnel Assessment (''PA'').[12]

- *The NASD's Response to Comments*

The NASD filed the instant proposed rule change because revenue generated by the TAF at the original rate was lower than expected.[13] The NASD noted that it originally proposed a TAF rate of .0001 per share, but reduced the rate to 0.00005 ''after informal feedback from the membership about the level of volume meeting the definition of 'covered equity security.' '' [14] The NASD filed the instant proposed rule change to remedy a shortfall in revenue.[15]

With regard to the CSE's comments that (i) the NASD has not adequately defined its responsibilities, nor has it established a sufficient nexus between its responsibilities and fees; and (ii) where intermarket fees are being assessed, a higher standard of scrutiny should be applied, the NASD noted that the Commission addressed both of these issues in its order approving the TAF.[16]

Finally, the NASD explained that the TAF does not underwrite ''the regulation of Nasdaq and the Alternative Display Facility'' and that the TAF, GIA, and PA fund the NASD's member regulatory programs.[17]

III. Discussion and Commission Findings

The Commission has reviewed carefully the proposed rule change, the comment letter, and the NASD's response to the comments, and finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association [18] and, in particular, the requirements of section 15A(b)(5) of the Act.[19] Section 15A(b)(5) requires, among other things, that the rules of a national securities association provide for the equitable allocation of reasonable dues, fees, and other charges among members and issuers and other persons using any facility or system which the association operates or controls. The Commission finds that the proposed increase in the rate for the TAF as described in the instant proposed rule change is consistent with section 15A(b)(5) of the Act, in that the proposal is reasonably designed to recover NASD costs related to regulation and oversight of its members.

The Commission believes the CSE Letter raises no novel issues that were not addressed in the Commission's original TAF approval order.[20] The Commission also believes that the NASD adequately responded to the issues the CSE raised in its letter.

The Commission expects that the NASD will continue to monitor the revenue generated by the TAF, as well as the revenue generated by the Gross Income Assessment and the Personnel Assessment, and will take whatever steps are necessary to ensure that the fees remain consistent with the mandate established in section 15A(b)(5) of the Act,[21] so that the fees remain equitable, as well as consistent with the NASD's expressed goal.

IV. Conclusion

It is therefore Ordered, pursuant to section 19(b)(2) of the Act[22], that the proposed rule change (SR–NASD–2003–93) be, and it hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[23]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 03–19660 Filed 8–1–03; 8:45 am]

BILLING CODE 8010–01–P

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–48239; File No. SR–NASD–2003–98]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by National Association of Securities Dealers, Inc., Regarding Reporting of Transactions Conducted Through Electronic Communications Networks to the Automated Confirmation Transaction Service

July 28, 2003.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] and Rule 19b–4 thereunder,[2] notice is hereby given that on June 19, 2003, National Association of Securities Dealers, Inc. (''NASD''), through its subsidiary, The Nasdaq Stock Market, Inc. (''Nasdaq''), filed with the Securities and Exchange Commission (''Commission'') the proposed rule change as described in Items I, II, and III below, which Items have been prepared by Nasdaq. The Exchange submitted an amendment to the proposed rule change on January 27, 2003.[3] The Commission is publishing

[5] *See* July 23, 2003 letter from Barbara Z. Sweeney, Senior Vice President and Corporate Secretary, NASD, to Katherine A. England, Assistant Director, Division of Market Regulation, SEC (''NASD Response Letter'').

[6] *See* footnote 4, *supra.*

[7] CSE Letter at 1.

[8] *Id.* at 2.

[9] *Id.*

[10] *Id.* at 3.

[11] *Id.*

[12] *Id.* at 4.

[13] NASD Response Letter at 1.

[14] *Id.* at 1–2.

[15] *Id.* at 2.

[16] *Id.*

[17] *Id.* at 3.

[18] In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

[19] 15 U.S.C.78o–3(b)(5).

[20] *See* Securities Exchange Act Release No. 47946 (May 30, 2003), 68 FR 34021 (June 6, 2003) (SR–NASD–2002–148)(approval order).

[21] 15 U.S.C. 78o–3(b)(5).

[22] 15 U.S.C. 78s(b)(2).

[23] 17 CFR 200.30–3(a)(12).

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] *See* Letter from John Yetter, Associate General Counsel, Nasdaq, to Kathy England, Assistant Director, Division of Market Regulation, Commission, dated July 10, 2003 (''Amendment No.

Continued

this notice, as amended, to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of the Substance of the Proposed Rule Change

Nasdaq proposes to clarify the reporting requirements applicable to transactions conducted through electronic communications networks (''ECNs'') and reported to the Automated Confirmation Transaction Service (''ACT''). ECNs would be required to file Automated Confirmation Transaction Service (''ACT''). ECNs would be required to file notice of their methods for trade reporting under the proposed rule change within 30 calendar days after the date of Commission approval.

The text of the proposed rule change is below. Proposed new language is in italics; proposed deletions are in brackets.

5400. NASDAQ STOCK MARKET AND ALTERNATIVE DISPLAY FACILITY TRADE REPORTING

* * * * *

5430. Transaction Reporting

(a) No change.

(b) Which Party Reports Transaction and to Which Facility

(1) In transactions between two Registered Reporting Nasdaq Market Makers, the member representing the sell side shall report the trade using ACT.

(2) In transactions between a Registered Reporting Nasdaq Market Maker and a Non-Registered Reporting Member, the Registered Reporting Nasdaq Market Maker shall report the trade using ACT.

(3) In transactions between two Non-Registered Reporting Members, the member representing the sell side shall report the trade using ACT or TRACS.

(4) In transactions between a member and a customer, the member shall report as follows:

(A) A Registered Reporting Nasdaq Market Maker shall report the trade using ACT;

(B) A Registered Reporting ADF Market Maker shall report the trade using TRACS; and

(C) A Non-Registered Reporting Member shall report the trade using ACT or TRACS.

(5) In transactions between two Registered Reporting ADF Market Makers, the member representing the sell side shall report the trade using TRACS.

(6) In transactions between a Registered Reporting ADF Market Maker and a Non-Registered Reporting Member, the Registered Reporting ADF Market Maker shall report the trade using TRACS.

(7) In transactions between a Registered Reporting Nasdaq Market Maker and a Registered Reporting ADF Market Maker, the member representing the sell side shall report as follows:

(A) A Registered Reporting Nasdaq Market Maker shall report the trade using ACT; and

(B) A Registered Reporting ADF Market Maker shall report the trade using TRACS.

(8) If a member simultaneously is a Registered Reporting Nasdaq Market Maker and a Registered Reporting ADF Market Maker, and has the trade reporting obligation pursuant to paragraphs (1), (2), (4), (5), (6), or (7), the member can report the trade using either ACT or TRACS, unless the trade is executed using ACES; the Nasdaq National Market Execution System (''NNMS''); [the SelectNet Service; the SmallCap Small Order Execution System (''SOES'');] or the Primex Auction System (''Primex''). A trade executed using ACES must be reported using ACT, and trades executed using NNMS[, SelectNet, SOES,] or Primex will be reported to ACT automatically.

(9) In transactions conducted through an ACT ECN (as defined in Rule 6110) that are reported to ACT, the ACT ECN shall ensure that transactions are reported in accordance with Rule 6130(c). If an ACT ECN is also a Registered Reporting ADF ECN (as defined in Rule 4200A), Rule 6130(c) shall apply only to transactions conducted through the ECN for which trade reports are submitted to ACT.

* * * * *

6100. AUTOMATED CONFIRMATION TRANSACTION SERVICE (ACT)

6110. Definitions

(a)–(p) No change.

(q) The term ''ACT ECN'' shall mean a member of the Association that is an electronic communications network that is a member of a registered clearing agency for clearing or comparison purposes or has a clearing arrangement with such a member, to the extent that transactions executed through it are reported to ACT.

* * * * *

6130. Trade Report Input

(a)–(b) No change.

(c) Which Party Inputs Trade Reports to ACT.

ACT Participants shall, subject to the input requirements below, either input trade reports into the ACT system or utilize the Browse feature to accept or decline a trade within the applicable time-frames as specified in paragraph (b) of this Rule. Trade data input obligations are as follows:

(1) in transactions between a Market Maker and an Order Entry Firm, the Market Maker shall be required to submit a trade report to ACT;

(2) in transactions between two Market Makers, the member representing the sell side shall be required to submit a trade report to ACT;

(3) in transactions between two Order Entry Firms, the member representing the sell side shall be required to submit a trade report to ACT[.];

(4) in transactions between a member and a customer, the member shall be required to submit a trade report to ACT;

(5) in transactions conducted through an ACT ECN that are reported to ACT, the ACT ECN shall ensure that transactions are reported in accordance with one of the following methods:

(A) the ACT ECN shall submit the trade reports to ACT and identify itself as the reporting party;

(B) the ACT ECN shall submit the trade reports to ACT on behalf of the reporting party and identify the reporting party in accordance with the rules for determining reporting parties reflected in paragraphs (1), (2), (3), and (4) above; or

(C) the ACT ECN shall require one of the parties, determined in accordance with the rules for determining reporting parties reflected in paragraphs (1), (2), (3), and (4) above, to submit the trade reports to ACT.

When an ACT ECN reports transactions in accordance with subparagraph (A), the ACT ECN shall be responsible for ensuring that the trade reports are accurate and contain all information required by subsection (d) of this rule for both the ACT ECN and the identified non-reporting party. When an ACT ECN reports transactions in accordance with subparagraph (B), both the ACT ECN and the party identified as the reporting party shall be responsible for ensuring that the trade reports are accurate and contain all information required by subsection (d) of this rule for both the ACT ECN and the identified reporting party. When an ACT ECN requires reporting of transactions in accordance with subparagraph (C), the reporting party shall be responsible for ensuring the accuracy and completeness of the trade report.

1''). Amendment No. 1 deletes the reference in NASD Rule 6130(c)(6) to subparagraph (3) because this provision would not apply to ECNs.

An ACT ECN shall provide written notice to the Association of the method of trade reporting used by the ACT ECN for each of its subscribers, and may change the method of trade reporting used for a subscriber by providing advance written notice of the change to the Association;

(6) in transactions conducted through two ACT ECNs or an ACT ECN and an ECN that is not an ACT ECN, an ACT ECN shall be responsible for complying with the requirements of paragraph (5) above for reporting a transaction executed through its facilities, and an ECN that routed an order to it for execution shall be deemed to be a Market Maker and a member for purposes of the rules for determining reporting parties reflected in paragraphs (1), (2), and (4) above; and

(7) in transactions conducted through an ACT ECN in which neither of the parties is a member, the ACT ECN shall report the transaction in accordance with the requirements of subparagraph (5)(A) above.

(d)–(e) No change.

* * * * *

6400. REPORTING TRANSACTIONS IN LISTED SECURITIES

* * * * *

6420. Transaction Reporting

(a) No change.

(b) Which Party Reports Transaction

(1) Transactions executed on an exchange are reported by the exchange and shall not be reported by members.

(2) In transactions between two Registered Reporting Members, only the member representing the sell side shall report.

(3) In transactions between a Registered Reporting Member and a Non-Registered Reporting Member, only the Registered Reporting Member shall report.

(4) In transactions between Non-Registered Reporting Members, only the member representing the sell side shall report.

(5) In transactions conducted through an ACT ECN (as defined in Rule 6110), the ACT ECN shall ensure that the transactions are reported in accordance with Rule 6130(c).

(c)–(e) No change.

IM–6420. Transactions in Eligible Securities

SUMMARY OF PROVISIONS GOVERNING MEMBERS' REQUIREMENTS TO REPORT TRANSACTIONS IN ELIGIBLE SECURITIES
CHART I.—GENERAL REPORTING REQUIREMENTS UNDER RULE 6420(B)

Member	Transaction	Member reports when contra-party is			
		[Designated] *Registered* Reporting Member	Non-[Designated] *Registered* Reporting Member	Exchange	Customer
[Designated] *Registered* Reporting Member	Buys from	No	Yes	No	Yes.
	Sells to	Yes	Yes	No	Yes.
Non-[Designated]	Buys from	No	No	No	Yes.
Non-[Designated] *Registered* Reporting Member	Buys from customer and sells to.	No	Yes	No	Yes.
	Sells to customer and buys from.	No	No	No	Yes.
Registered Reporting Member	Sells to	No	Yes	No	Yes.
ACT ECN		*See 6130(c)*	*See 6130(c)*	*No*	*See 6130(c)*

CHART II.—REPORTING REQUIREMENTS FOR "RISKLESS" TRANSACTIONS AS DEFINED IN RULE 6420(D)(4)

Member	Transaction	Member Reports When Contra-Party Is			
		[Designated] *Registered* Reporting Member	Non-[Designated] *Registered* Reporting Member	Exchange	Customer
[Designated] *Registered* Reporting Member	Buys from customer and sells to	Yes	Yes	No	Yes.
	Sells to customer and buys from	No	Yes	No	Yes.

* * * * *

6600. REPORTING TRANSACTIONS IN OVER-THE-COUNTER SECURITIES

* * * * *

6620. Transaction Reporting

(a) No change.

(b) Which Party Reports Transaction

(1) In transactions between two OTC Market Makers, only the member representing the sell side shall report.

(2) In transactions between an OTC Market Maker and a Non-Market Maker, only the OTC Market Maker shall report.

(3) In transactions between two Non-Market Makers, only the member representing the sell side shall report.

(4) In transactions between a member and a customer, the member shall report.

(5) In transactions conducted through an ACT ECN (as defined in Rule 6110), the ACT ECN shall ensure that the transactions are reported in accordance with Rule 6130(c), and the term "Market Maker" as used in such rule shall be construed to include an OTC Market Maker.

(c)–(e) No change.

* * * * *

6900. REPORTING TRANSACTIONS IN DIRECT PARTICIPATION PROGRAMS

6920. Transaction Reporting

(a) No change.

(b) Which Party Reports Transactions

(1) In transactions between two members, only the member representing the sell side shall report.

(2) In transactions between a member and a customer, the member shall report.

(3) In transactions conducted through an ACT ECN (as defined in Rule 6110), the ACT ECN shall ensure that the transactions are reported in accordance with Rule 6130(c); provided that for purposes of Rule 6130(c)(5)(B) and (C), the party with the reporting obligation shall be as set forth in Rule 6130(c)(3) and the term ''Order Entry Firm'' as used in such rule shall be construed to refer to any member.

(c)–(e) No change.

* * * * *

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, Nasdaq included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. Nasdaq has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

Nasdaq is proposing to adopt rules to define with greater clarity the reporting obligations applicable to transactions executed through ECNs that are reported to ACT. The proposal is based on Nasdaq's understanding of the different methods used by ECNs today to report trades, and in general, the rule filing is not intended to require ECNs to modify their current trade reporting practices. Rather, the purpose of the filing is to codify these practices in the form of clear, enforceable rules that will provide greater guidance to market participants.[4] The proposed rule change would apply to transactions in all securities that are executed through an ECN and reported to ACT.

Reporting of transactions executed through ECNs is complex because ECNs conduct transactions on an ''agency'' basis, with the ECN standing as a central contra party to two offsetting transactions with ECN subscribers. However, the substance of the transaction is the transference of shares from one ECN subscriber to another, and therefore only one transaction is reported to the tape for public dissemination.

Current practices of ECN trade reporting have developed over time in conjunction with the growth of the number of ECNs. As each new ECN entered the market, it registered with Nasdaq under NASD Rule 4623 and informed Nasdaq and NASD of its planned method for reporting transactions. Although Nasdaq believes that the use of different reporting methodologies by different ECNs has generally allowed ECNs to fulfill reporting obligations while tailoring their methodology to their own business needs and those of their subscribers, the absence of clearly defined rules has, in some circumstances, created confusion as to the trade reporting responsibilities of ECNs and their subscribers. Nasdaq believes that the proposed rule change will provide members greater certainty concerning their trade reporting responsibilities, while allowing ECNs to continue using the various methods of trade reporting that have developed over time.

The proposed rule change permits ECNs to use any of three methods for reporting transactions.[5] Each ECN would inform NASD which method it would use for reporting trades to ACT for each of its subscribers, but it could change its method at any time by providing advance notice to NASD.[6] First, an ECN may assume sole responsibility for reporting transactions executed through its facilities and identify itself as the reporting party. Second, an ECN may assume sole responsibility for transaction reporting, but identify a subscriber as the reporting party. In that case, the identified reporting party would be determined in accordance with the existing rules for allocating trade reporting responsibility. Thus, if the subscribers conducting a transaction through the ECN were both market makers or both order entry firms, the selling party would be identified as the reporting party; if the transaction were between a market maker and an order entry firm, the market maker would be identified as the reporting party; and if the transaction were between a member (*i.e.*, a broker-dealer) and a non-member (such as an institutional investor), the member would be identified as the reporting party.

Third, the ECN may impose some or all of the responsibility for reporting on its subscribers. In that case, the ECN would notify the appropriate reporting party, determined in accordance with the existing rules of priority for trade reporting, that it had an obligation to submit a report concerning the trade.

In each case, the party submitting a trade report is responsible for ensuring its accuracy and completeness.[7] In addition, when an ECN submits a trade report identifying another party as the reporting party, both the ECN and the identified reporting party are responsible for ensuring the accuracy and completeness of the report.

The proposed rule change also addresses procedures for reporting transactions in several unique circumstances associated with ECNs. First, the rule provides that when the parties to a transaction executed through an ECN are both non-members, the ECN must submit all required trade reports and identify itself as the reporting party. This is the case because as non-members, the parties to the transaction would not be eligible to report trades through ACT. Second, in circumstance where one ECN routes an order to another ECN that executes the order, the ECN that executes the order would be responsible for reporting the transaction, or requiring a subscriber to report the transaction, in accordance with one of the three basic methods for trade reporting described above. For purposes of the rules for allocating trade reporting responsibility between ECN subscribers, the routing ECN would be deemed to be a market maker. Thus, if the executing ECN uses the second method of trade reporting, and it receives an order from a routing ECN that is matched against the order of an order entry firm or a non-member customer, the routing ECN would be identified as the reporting party. If the executing ECN matched the routed order against the order of a market maker or another ECN, however, the sell

[4] The proposed rules are intended to provide greater certainty while Nasdaq remains a subsidiary of the NASD, and do not impact the trade reporting rules filed by Nasdaq in its application to register as an exchange, which are different from the current proposal.

[5] As discussed earlier, the three methods are based on ECN trade reporting practices. Nasdaq also understands that, at any given time, an ECN may utilize more than one of these methods and the choice of the method varies depending on the needs of particular subscribers. For example, ECN A may use one method for subscriber B and another method for subscriber C. This proposal is not intended to limit this flexibility. Accordingly, an ECN will be permitted to use more than one of the methods described in Rule 6130(c), as long as it provides NASD written notice concerning the methods that it will use for each subscriber.

[6] Notices must be filed with Nasdaq's Market Watch Department and NASD's Market Regulation Department.

[7] Rule 6130(d) specifies the information that is required to be included in each ACT report.

side would be identified as the reporting party.

Finally, it should be noted that the proposed rule change applies only to transactions that are reported to ACT, since Nasdaq does not have authority to establish rules governing the reporting of trades to non-Nasdaq systems. Thus, in circumstances where an ECN has the option to report trades to ACT or to another trade reporting system, such as the NASD's TRACS system, the rule does not mandate that the ECN use ACT for trade reporting. However, to the extent that the ECN or its subscribers opt to use ACT to report a particular transaction, all provisions of the proposed rule change would apply to that transaction.[8] In addition to the above changes, Nasdaq is also removing references to ''Select Net Service'' and the ''SmallCap Small Order Execution System'' from NASD Rule 5430(b)(8) because these systems are no longer in place.[9]

2. Statutory Basis

Nasdaq believes that the proposed rule change is consistent with the provisions of section 15A of the Act,[10] in general, and with section 15A(b)(6) of the Act,[11] in particular, in that it is designed to prevent fraudulent and manipulative acts and practices, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, and to protect investors and the public interest. Nasdaq purports that the proposed rule change will clarify the trade reporting obligations associated with transactions conducted through ECNs. Nasdaq believes that the adoption of clear, enforceable rules will provide guidance to market participants and thereby provide greater assurance of comprehensive reporting of ECN transactions.

B. Self-Regulatory Organization's Statement on Burden on Competition

Nasdaq does not believe that the proposed rule change, as amended, will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

[8] The proposed rule change also corrects several typographical errors in IM–6420.

[9] Telephone call between John Polise, Senior Special Counsel, Sonia Trocchio, Special Counsel, and Leah Mesfin, Attorney, Division, Commission, and John Yetter, Assistant General Counsel, and Peter Geraghty, Associated Vice President and Associate General Counsel, Office of the General Counsel, Nasdaq on July 9, 2003.

[10] 15 U.S.C. 78*o*–3.

[11] 15 U.S.C. 78*o*–3(6).

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

Written comments were neither solicited nor received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which NASD consents, the Commission will:

A. By order approve such proposed rule change, or

B. institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposal, as amended, is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to file number SR–NASD–2003–98, and should be submitted by August 25, 2003.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[12]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 03–19724 Filed 8–1–03; 8:45 am]

BILLING CODE 8010–01–P

[12] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–48252; File No. SR–NASD–2002–154; SR–NYSE–2002–49]

Self-Regulatory Organizations; Order Approving Proposed Rule Changes by the New York Stock Exchange, Inc. Relating to Exchange Rules 344 (''Supervisory Analysts''), 345A (''Continuing Education for Registered Persons''), 351 (''Reporting Requirements'') and 472 (''Communications with the Public'') and by the National Association of Securities Dealers, Inc. Relating to Research Analyst Conflicts of Interest and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 3 to the Proposed Rule Change by the New York Stock Exchange, Inc. and Amendment No. 3 to the Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Research Analyst Conflicts of Interest

July 29, 2003.

I. Introduction

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the ''Exchange Act'' or ''Act''),[1] and Rule 19b–4 thereunder,[2] on October 9, 2002, the New York Stock Exchange, Inc. (''NYSE'' or ''Exchange''), and on October 25, 2002, the National Association of Securities Dealers (''NASD''), filed with the Securities and Exchange Commission (''SEC'' or ''Commission'') proposed rule changes relating to research analyst conflicts of interest.

On December 4, 2002, NYSE submitted Amendment No. 1 to its proposed rule change [3] and on December 18, 2002, NASD submitted Amendment No. 1 to its proposed rule change.[4] The proposed rule changes, as

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] *See* Letter from Darla Stuckey, Corporate Secretary, NYSE, to James A. Brigagliano, Assistant Director, Division of Market Regulation (''Division''), Commission (''NYSE Amendment No. 1''). NYSE Amendment No. 1 conformed aspects of the proposed NYSE rules to those of NASD (*See* SR–NASD–2002–154), and proposed effective dates for the various rule provisions.

[4] *See* Letter from Philip Shaikun, Assistant General Counsel, NASD, to Katherine A. England, Assistant Director, Division, Commission (''NASD Amendment No. 1''). NASD Amendment No. 1 clarified that only research analysts who are directly responsible for the preparation of research reports would be required to register with NASD and pass a qualification examination (*See* proposed NASD Rule 1050). NASD Amendment No. 1 also conformed NASD's proposed research analyst compensation provisions to comparable NYSE provisions. NASD Amendment No. 1 also amended

Continued

amended, were published for comment in the **Federal Register** on January 7, 2003.[5] The comment period expired on March 10, 2003. The Commission received 19 comment letters on the proposed rule changes from 18 different commenters in response to the Original Notice.[6]

On May 16, 2003, NYSE filed with the Commission Amendment No. 2 to its proposed rule change (''NYSE Amendment No. 2''), and on May 20, 2003, the NASD filed Amendment No. 2 to its proposed rule change (''NASD Amendment No. 2''). NYSE Amendment No. 2 and NASD Amendment No. 2 were published together in the **Federal Register** on May 29, 2003.[7] The comment period expired on June 19, 2003. The Commission received seven comment letters in response to the notice.[8] On July 29, 2003, the NASD submitted a letter responding to comments.[9] On July 29, 2003, NYSE filed Amendment No. 3 to its proposed rule change (''NYSE Amendment No. 3''), which included its response to comments. On July 29, 2003, NASD filed Amendment No. 3 to its proposed rule change (''NASD Amendment No. 3''). This order approves the proposed rule changes, as amended by NASD Amendment Nos. 1, 2, and 3, and by NYSE Amendment Nos. 1, 2, and 3. The Commission also seeks comment from interested persons on NYSE Amendment No. 3 and NASD Amendment No. 3.

II. Background

On May 10, 2002, the Commission approved rule changes filed by the NYSE and NASD (the ''SROs'') governing research analyst conflicts of interest.[10] Those rules took considerable steps towards promoting greater independence of research analysts and significantly enhanced the disclosure of actual and potential conflicts of interest to investors. In the Original Notice, the Commission published for comment a second set of proposed rules filed by the SROs to further address research analyst conflicts of interest. In its May 10, 2002 approval order of the first round of new analyst rules, the Commission asked the SROs to report on the operation and effectiveness of those rules on or before November 1, 2003. In light of the approval of these additional rules and the Global Settlement,[11] the Commission believes that a report at that time may be premature. Thus, the Commission will request a report from the SROs when it deems such report warranted. On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 (''SOA''), which requires, among other things, that the Commission, or upon authorization and direction of the Commission, a registered securities association or national securities exchange, [12] adopt rules governing analyst conflicts.[13]

Certain of the SOA's mandates were satisfied by NASD and NYSE rule provisions existing at the time of the enactment of the SOA. Other of the SOA's mandates necessitated amendments to the existing rules. The SOA requires rules governing analyst conflicts of interest, including rules: limiting the supervision and compensatory evaluation of securities analysts to certain officials; defining periods in which brokers or dealers engaged in a public offering of a security as an underwriter or dealer may not publish research on such security; and requiring securities analysts and brokers or dealers to disclose specified conflicts of interest. The primary purposes of NASD Amendment No. 2 and NYSE Amendment No. 2 were to satisfy the remaining SOA requirements.

In February 2003, the Commission approved Regulation Analyst Certification (''Regulation AC''), which requires that broker-dealers (and certain associated persons) include in research reports a statement by the research analyst certifying that the views expressed in the research report accurately reflect his or her personal views; and a statement by the research analyst certifying either that no part of his or her compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report; or that part or all of his or her compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report.[14]

On April 28, 2003, the Commission, along with other regulators, announced a global settlement of enforcement actions against ten of the nation's largest investment firms that followed joint investigations by regulators of allegations of undue influence of investment banking interests on securities research at brokerage firms. [15]

A. Current NYSE and NASD Rules Governing Disclosure of Conflicts of Interest

In the May 2002 approval order, prior to the enactment of the SOA, the Commission approved rule changes filed by the SROs governing analyst conflicts of interest. Those rule changes were designed to address analyst conflicts of interest in connection with the preparation and publication of research reports and public appearances

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the definition of ''research report'' to conform it to the definition in the Sarbanes-Oxley Act of 2002. NASD Amendment No. 1 also revised certain language that was contained in the discussion of the proposed amendment concerning print media interviews and articles.

[5] *See* Securities Exchange Act Release No. 47110 (December 31, 2002), 68 FR 826 (''Original Notice'').

[6] *See* Letters to Jonathan G. Katz, Secretary, Commission, from: Adams, Harkness & Hill, Inc., AG Edwards, Keefe, Bruyette & Woods, Inc., Pacific Growth Equities, LLC, RBC Capital Markets, Stephens Inc., Stifel Nicolaus & Company, and William Blair & Company, dated March 10, 2003 (''Adams et al''); The Advest Group, Inc., dated April 28, 2003 (''Advest''); Association for Investment Management and Research, dated March 6, 2003 (''AIMR March 6th''); Bloomberg News, dated February 19, 2003 (''Bloomberg''); Charles Schwab Corporation, dated March 20, 2003 (''Schwab March 20th''); Credit Suisse First Boston, dated April 16, 2003 (''CSFB''); Gibson, Dunn & Crutcher LLP, dated March 10, 2003 (''Gibson''); Investment Company Institute, dated March 10, 2003 (''ICI March 10th''); Investorside Research Association, dated March 10, 2003 (''Investorside''); Vahan Janjigian, dated February 27, 2003; Robert Lin, dated November 17, 2002; Newspaper Association of America, dated March 10, 2003 (''NAA''); North American Securities Administrators Association, Inc., dated March 10, 2003 (''NASAA''); Securities Industry Association, letters dated March 10, 2003 (''SIA March 10th'') and May 9, 2003 (''SIA May 9th''); Stifel, Nicolaus & Company, Incorporated, dated March 10, 2003 (''Stifel''); SunTrust Capital Markets, Inc., dated March 10, 2003 (''SunTrust''); Weiss Ratings, Inc., dated March 10, 2003 (''Weiss''); Wilmer Cutler & Pickering, dated March 11, 2003 (''Wilmer March 11th'').

[7] *See* Securities Exchange Act Release No. 47912 (May 22, 2003), 68 FR 103 (''May 29th Notice'').

[8] *See* Letters to Jonathan G. Katz, Secretary, Commission, from: Association for Investment Management and Research, dated July 15, 2003 (''AIMR July 15th''); Banc of America Securities LLC, dated June 26, 2003 (''BOA''); Charles Schwab Corporation, dated June 30, 2003 (''Schwab June 30th''); Investment Company Institute, dated June 19, 2003 (''ICI June 19th''); Investment Counsel Association of America, dated June 19, 2003 (''ICAA''); Securities Industry Association, dated June 26, 2003 (''SIA June 26th''); Sullivan & Cromwell LLP, dated June 19, 2003 (''Sullivan''); Wilmer Cutler & Pickering, dated June 25, 2003 (''Wilmer June 25th'').

[9] *See* Letter from Philip A. Shaikun, Associate General Counsel, NASD to James A. Brigagliano, Assistant Director, Division, Commission (July 29, 2003) (''NASD Response to Comments'').

[10] *See* Securities Exchange Act Release No. 45908, 67 FR 34968 (May 16, 2002) (''May 2002 approval order'').

[11] *See* note 15 *infra.*

[12] *See* Letter from Annette Nazareth, Director, Division of Market Regulation, Commission, to Mary Schapiro, Vice Chairman and President, Regulatory Policy and Oversight, NASD, and Richard Grasso, Chairman and Chief Executive Officer, NYSE (March 13, 2003).

[13] *See* Pub. L. 107–204, 116 Stat. 745 (2002). The SOA amends the Exchange Act by adding new Section 15D. *See* 15 U.S.C. 78a *et seq.*; 15 U.S.C. 78*o*–6.

[14] *See* Securities Exchange Act Release No. 47384 (February 20, 2003), 68 FR 9482 (February 27, 2003).

[15] The terms of the settlement are available at *http://www.sec.gov/litigation/litreleases/finaljudgadda.pdf* (''Global Settlement'').

made on equity securities. The rules contain a number of elements, including:

- A prohibition on offering favorable research to induce investment banking business;
- Structural reforms to increase analyst independence, including a prohibition on investment banking personnel supervising analysts or approving research reports;
- A prohibition on tying analyst compensation to a specific investment banking services transaction;
- Increased disclosures of conflicts of interest in research reports and public appearances by analysts;
- Restrictions on personal trading by analysts; and
- Disclosure in research reports of data and price charts showing the firm's ratings track record.

B. Proposed Changes to NYSE and NASD Rules

The proposed SRO rule changes further address research analyst conflicts of interest in connection with equity research reports, and are designed to achieve full compliance with the mandates of the SOA. The Commission provides here a general overview of the proposed rule changes. The Commission notes, in particular, that while the NASD and NYSE rules may differ to some degree in their texts, the provisions are intended to operate in substantially the same way.[16]

First, the proposals further separate research analyst compensation from investment banking influence. Specifically, the proposals require that a compensation committee of the broker-dealer review and approve the compensation of its research analysts that are primarily responsible for the preparation of the substance of research reports. The committee would report to the Board of Directors and may not have representation from the firm's investment banking department. Among other things, the committee would consider the analyst's individual performance (*e.g.*, quality of research product); correlation between a research analyst's recommendations and stock prices; and overall ratings from various internal or external parties exclusive of the firm's investment banking personnel. The committee may not consider a research analyst's contribution to the firm's overall investment banking business. In addition, in order to comply with the SOA, the proposals prohibit investment banking personnel influence or control over the compensatory evaluation of research analysts.

Second, the proposed rules prohibit analysts from issuing positive research reports or reiterating a ''buy'' recommendation around the expiration of a lock-up agreement (sometimes called ''booster shot'' research reports). The proposals accomplish this by prohibiting the issuance of research reports by the manager or co-manager of a securities offering for fifteen days prior to and after the expiration of lock-up agreements.

Third, the amendments extend the current ten and forty-day quiet periods for the issuance of written research reports to communications in public appearances by managers and co-managers of initial and secondary offerings. The proposals also establish a 25-day quiet period during which broker-dealers who have agreed to participate (or who are participating) as underwriters or dealers (other than a manager or co-manager) of an issuer's initial public offering would be prohibited from publishing research reports and analysts would be prohibited from making public appearances regarding that issuer.

Fourth, the proposed rules further insulate research analysts from investment banking interests by prohibiting analysts from participating in ''pitches'' or other communications for the purpose of soliciting investment banking business.

Fifth, the proposed rules require that a member provide notice to customers that it is terminating research coverage of an issuer that is the subject of a research report (''subject company''). The final report must include a final recommendation or rating (unless it is impracticable to do so).

Sixth, the proposed SRO rule changes restrict the prepublication review and approval of research reports by persons not directly responsible for research. The rules also require that prepublication communications about the content of a research report between all non-research personnel and the research department be intermediated by legal or compliance staff.

Seventh, the proposals prohibit members engaged in investment banking activities from directly or indirectly retaliating, or threatening to retaliate, against a research analyst who publishes a research report or makes a public appearance that may adversely affect the member's present or prospective investment banking relationship. The SROs have clarified in the rules that the anti-retaliation provision would not preclude termination of a research analyst, in accordance with the member's policies and procedures, for causes unrelated to issuing or distributing such adverse research or for making an unfavorable public appearance regarding the member's current or potential investment-banking relationship with the issuer.

Eighth, the proposals expand on the current SRO compensation disclosure requirements by requiring disclosure by a member in research reports, to the extent the member knows or has reason to know, and by a research analyst in public appearances, to the extent the analyst knows or has reason to know, of whether the member, or any affiliate thereof (including the research analyst), received any compensation during the past twelve months from the issuer that is the subject of the report or public appearance. The rule changes further require disclosure of whether the subject company is, or has been during the previous year, a client of the member, and if so, the types of services provided to the issuer. The types of services provided to the subject company must be described as: (1) Investment banking services, (2) non-investment banking securities-related services, or (3) non-securities services. Both the compensation disclosure and the client services disclosure provisions provide for an exception in order to prevent the disclosure of material non-public information regarding specific potential future investment banking transactions of the issuer.

Ninth, the proposed SRO rule changes also create an exception from the existing ''gatekeeper'' provisions of the SRO rules for certain members that engage in limited underwriting activity.[17] The gatekeeper provisions prohibit a research analyst from being subject to the supervision or control of any employee of a member's investment banking department, and further require legal or compliance personnel to intermediate certain communications between research and investment banking personnel.

Tenth, the proposed rules require that legal or compliance personnel pre-approve all securities transactions of persons who oversee research analysts, including the members of a committee and certain others, that have direct influence or control with respect to the preparation of research reports or establishing or changing a rating or price target of a subject company's equity securities, to the extent that the transactions involve securities of subject

[16] *See* NASD Amendment No. 3 and NYSE Amendment No. 3.

[17] *See* NYSE Rule 472(b)(1) and (3), and NASD Rule 2711(b)(1) and (3) (''gatekeeper'' provisions).

companies covered by research analysts that they oversee.

Finally, the proposed rules impose additional registration, qualification, and continuing education requirements on research analysts. The proposed amendments would establish a new registration category and require a qualification examination for research analysts. The proposals would also impose requirements regarding the continuing education of certain registered persons consisting of a Regulatory Element and a Firm Element [18] to address applicable rules and regulations, ethics, and professional responsibility.

III. Discussion

The Commission received a total of 26 comment letters from 22 commenters on the proposed rule changes.[19] As discussed in detail below, although commenters generally supported the fundamental goals and objectives behind the proposed rule changes, many commenters also believed that certain of the initial proposals should be revised, and some suggested substantive changes. In response to various concerns and suggestions raised by commenters, the NYSE filed NYSE Amendment No. 3, and the NASD filed NASD Amendment No. 3, to their proposed rule changes.

After careful review, the Commission finds, as discussed more fully below, that the proposed rule changes, as amended, are consistent with the requirements of the Exchange Act and the regulations thereunder applicable to the NYSE and NASD.[20] In particular, the Commission believes that the proposals are consistent with Sections 6(b)(5) and 6(b)(8) of the Exchange Act,[21] Sections 15A(b)(6) and 15A(b)(9) of the Exchange Act,[22] and Section 15D of the Exchange Act, which was enacted as part of the SOA.

Section 6(b)(5) requires, among other things, that the rules of an exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of free trade, to remove impediments to and perfect the mechanism of a free and open market, and to protect investors and the public interest. Section 6(b)(5) also requires that the rules of an exchange not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers. Section 6(b)(8) of the Exchange Act prohibits the rules of an exchange from imposing any burden on competition not necessary or appropriate in furtherance of the purposes of the statute.

Section 15A(b)(6) requires that the rules of a registered national securities association 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. Section 15A(b)(9) requires that the rules of an association not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The Commission also believes that the rules, as amended, fulfill the mandates of the SOA [23] that require that rules be implemented that are reasonably designed to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances, and to improve the objectivity of research, provide investors with more useful and reliable information, and to require disclosure in public appearances and research reports of conflicts of interest that are known or should have been known by the securities analyst or the broker-dealer to exist at the time of the appearance or the date of distribution of the report.

Section 3(f) of the Exchange Act directs the Commission to consider, in addition to the protection of investors, whether approval of a rule change will promote efficiency, competition, and capital formation.[24] In approving the proposed rule changes, the Commission has considered their impact on efficiency, competition, and capital formation.

The Commission believes the rule changes, as amended, promote the independence of research analysts and the objectivity of research. The rule proposals are reasonably designed to require analysts to disclose in public appearances, and broker-dealers to disclose in research reports, conflicts of interest of which they know or should know to exist at the time of the appearance or the date of the report. As such, the rules should provide investors with more useful and reliable information and promote greater public confidence in securities research.

A. Solicitation of Investment Banking Business [NYSE Rule 472(b)(5) and NASD Rule 2711(c)(4)]

Under the initial proposals, a research analyst would have been prohibited from issuing research reports or making public appearances concerning a company if the analyst engaged in any communication with the company in ''furtherance of obtaining investment banking business'' prior to the time the company entered into a letter of intent or other written agreement that designated the analyst's firm as underwriter of the company's initial public offering.

Commenters expressed substantial concern regarding this provision, largely arguing that the phrase ''in furtherance of obtaining investment banking business'' was overly broad and several suggested alternative language.[25] They also expressed concern that the vagueness of the proposals would discourage analysts from visiting and communicating with private companies because firms would be unsure of what communications would, especially in hindsight, be considered ''in furtherance of obtaining investment banking business.'' [26]

Commenters also requested clarification on whether the consequence of a research analyst's participation in a communication ''in furtherance of obtaining investment banking business'' would be a permanent ban on the analyst writing research reports on that issuer, even where the analyst was no longer employed by the same firm. Commenters argued for a time limit on the research ban, and against the retroactive application to communications made prior to the effective date of the rule or in cases

[18] The Firm Element requires broker-dealers to keep employee education current by means of a formal, ongoing training program. Broker-dealers must ensure that training is relevant to identified needs and that it is adequate to convey the desired information relating to products and job functions. The Regulatory Element requires that broker-dealers conduct an annual needs analysis and focuses on compliance, regulatory, ethical, and sales-practice standards. All registered persons must participate in a prescribed computer-based training session within 120 days of their second registration anniversary date, and every third year thereafter. *See generally Content Outline For The Regulatory Element*, Securities Industry/Regulatory Council on Continuing Education (December 2000).

[19] *See* notes 6 and 8 *supra.*

[20] *See* 15 U.S.C. 19(b)(2).

[21] 15 U.S.C. 78f(b)(5) and (8).

[22] 15 U.S.C. 78*o*–3(b)(6) and (9).

[23] *See* Exchange Act Section 15D, 15 U.S.C. 78*o*–6.

[24] 15 U.S.C. 78c(f).

[25] *See* Adams *et al.* letter; SIA March 10th letter; Stifel letter; SunTrust letter; and Wilmer March 11th letter.

[26] *See* SIA March 10th letter; Stifel letter; and SunTrust letter.

where the research analyst is no longer employed by the same firm.[27]

Commenters also noted that the proposed provisions referred to the signing of a letter of intent, or other written agreement, in determining the date the firm received an investment-banking mandate. They argued that letters of intent are not common industry practice and, therefore, should not be used as evidence of the receipt of a mandate.[28]

The proposals also provided that the prohibition would not apply to ''due diligence communications'' between the research analyst and the subject company, the sole purpose of which is to analyze the financial condition and business operations of the subject company. Commenters requested clarification as to the meaning of ''due diligence communications'' and several suggested specific language or parameters.[29]

After considering commenters' concerns, the SROs modified their proposals in Amendment No. 3 to provide for an outright prohibition on research analyst participation in ''pitches'' for investment banking business or other communications with companies ''for the purpose of soliciting investment banking business.'' [30] While the original proposals sought to provide a disincentive for analyst involvement in pitches by prohibiting an analyst from preparing research reports on issuers with whom the analyst engaged in a pitch, the amended proposals take the approach of prohibiting analyst involvement in pitches.

The NASD believes that this amendment will not only promote regulatory consistency, but will also further the goals of research objectivity and investor confidence by eliminating all participation by research analysts in solicitation efforts, which could suggest a promise of favorable research in exchange for underwriting business.[31] Because the SROs believe that the same potential conflicts exist with respect to solicitation of all investment banking business, the amendment is not limited to initial public offerings.[32]

The final amendments also address commenters' concerns regarding what communications are permissible for research analysts. The SROs note that certain activities are traditionally associated with research functions within a multi-service securities firm, and are separate from the solicitation activities of concern that analysts may have recently been called upon to engage in by their firms.[33] For example, the NASD notes that the proposed amendment would not curtail research analysts from performing activities traditionally associated with research functions that do not involve solicitation of investment banking business, such as helping to screen potential investment banking clients.[34] The NYSE also recognizes the need for critical financial analysis of a subject company, during the period after the receipt of an investment banking mandate by the member while an issuer is preparing to engage in a securities offering to the public.[35] By prohibiting analyst participation in pitches and other activities involving the solicitation of investment banking business, the final amendments also avoid the implementation issues associated with the initial proposals.

The amended proposals further insulate research analysts from investment banking interests, while addressing commenters' concerns regarding vagueness, by clarifying the parameters of the kind of activities the rule is designed to address. The SROs note that the prohibition on analysts' involvement in solicitations of investment banking business is intended to support the prohibition on promising favorable research as a marketing tool to prospective investment banking clients of members, and is designed to encourage issuers to choose an investment banking firm based on the merits of the firm's underwriting capabilities.[36]

In our view, it is appropriate for the SROs to prohibit analyst involvement in pitches or other communications by research analysts that are made for the purpose of soliciting investment banking business. The Commission believes that the rules address concerns regarding analyst objectivity and independence from investment banking interests while permitting research analysts to provide certain services to their firm that several commenters viewed as valuable. The Commission also finds that the rules relating to research analyst involvement in solicitations for investment banking business are consistent with the Exchange Act, particularly Sections 6(b)(5), 6(b)(8), 15A(b)(6), and 15A(b)(9).

B. Compensation of Research Analysts [NYSE Rule 472(h) and NASD Rule 2711(d)]

The rule proposals reinforce the separation of research analyst compensation from investment banking influence by requiring procedures for review and approval of a research analyst's compensation by a committee that reports to the Board of Directors or a senior executive of the broker-dealer. No employee of a member's investment banking department may participate in the committee. At a minimum, the committee must consider the following factors: the research analyst's individual performance (*e.g.*, quality of research product), the correlation between a research analyst's recommendations and stock prices, and overall ratings from various internal (other than investment banking) or external parties.

Further, in reviewing and approving an individual research analyst's compensation, the committee may not consider his or her direct contribution to the firm's overall investment banking business. The basis for a research analyst's compensation would have to be documented and the committee must provide an annual attestation to certify that the committee reviewed and approved the compensation of research analysts who are primarily responsible for the preparation of the substance of research reports [37] and documented the basis for such approval.

Several commenters expressed concern regarding the compensation committee provisions and suggested alternatives.[38] One commenter believed that the ban on consideration by a compensation review committee of contributions to the firm's investment banking business should not preclude considering contributions to the extent that they benefit investors.[39] Other commenters asked for clarification that a member's overall profitability may be considered in determining a research

[27] *See* Adams *et al.* letter; SIA March 10th letter; SunTrust letter; and Wilmer March 11th letter.

[28] *See* SIA March 10th letter and Wilmer March 11th letter.

[29] *See* Adams *et al.* letter; SIA March 10th letter; Stifel letter; and Wilmer March 11th letter.

[30] The Global Settlement also prohibits research analyst involvement in ''pitches.''

[31] *See* NASD Response to Comments.

[32] *See* NASD Response to Comments and NYSE Amendment No. 3.

[33] *Id.*

[34] *See* NASD response to Comments.

[35] *See* NYSE Amendment No. 3.

[36] Promising favorable research to companies as an inducement for business is currently explicitly prohibited by NASD Rule 2711(e) and NYSE Rule 472(g). In addition, according to the SROs, promising favorable research to companies as an inducement for business would constitute a violation of just and equitable principles of trade. *See* Securities Exchange Act Release No. 45526 (March 8, 2002), 67 FR 11526 at 11539 (March 14, 2002) (Notice of SRO rules approved by the Commission in May 2002 approval order).

[37] The research analyst who is primarily responsible for the preparation of the substance of a research report is often referred to as the ''lead'' analyst. The Commission notes that a research report may have more than one lead analyst.

[38] *See* SIA March 10th letter, Stifel letter, and Weiss letter.

[39] *See* SIA March 10th letter.

analyst's compensation.[40] Others requested confirmation that a research analyst's compensation could be based not only on a member's overall profitability, but also on the profitability of a firm's capital markets division, investment banking department, or an industry group within an investment banking department, and requested that the SROs explicitly acknowledge certain additional permissible compensation factors set forth in the Global Settlement.[41]

The SROs agree that the general financial success of a member may be considered in determining analyst compensation.[42] NASD does not believe that it would be appropriate for a member to determine a research analyst's compensation based upon the profitability of the member's capital markets division, investment banking department, or some subgroup of such a division or department.[43] NASD acknowledges that several other factors may be appropriate to consider when determining compensation, the rules do not attempt to list all possible permissible considerations, and the NASD does not think it necessary to do so.[44]

Several commenters argued that the SRO rules should adopt the Global Settlement approach by applying obligations concerning how to calculate compensation only for the ''lead analyst'' (those analysts that are required to provide certifications under Regulation AC).[45] As such, commenters argued that the compensation committee provision should apply only to the compensation of analysts who are primarily responsible for a research report's substance.[46]

Upon consideration of commenters' concerns, the SROs agree that such a limitation on the scope of this provision is reasonable, and filed amendments to apply the compensation restrictions only to those research analysts who are primarily responsible for the preparation of the substance of a research report.[47] Thus, research analysts who are not primarily responsible for a research report's substance, such as junior analysts who report to the lead analyst, would not be covered by the compensation committee provision.

Commenters requested clarification on the intended role of the compensation committee and asserted that the proposed language was unclear as to whether the appropriate role of the committee was to ''review and approve'' research analyst compensation or to ''determine'' research analyst compensation; the commenter argued that the appropriate role for the committee should be to serve a review and approval function.[48]

The SROs amended the proposals to require that research analyst compensation be reviewed and approved by the compensation committee.[49] The amendments clarify that the committee must review and approve a research analyst's compensation. With the exception of the prohibitions of NYSE Rule 472(b)(1) and NASD Rule 2711(b)(1) on research analysts being subject to compensatory evaluation by investment banking personnel, the rules do not address who may initially determine that compensation.

The SOA requires that the ''compensatory evaluation'' of research analysts be limited to ''officials employed by the broker or dealer who are not engaged in investment banking activities.''[50] In order to satisfy the mandates of the SOA, the SROs have filed amendments to prohibit employees of the member's investment banking department from evaluating the compensation of research analysts.[51] As such, investment banking department personnel may not have input in determining research analyst compensation. Unlike the compensation committee provisions, this prohibition applies to the compensatory evaluation of all research analysts, and is not limited to those research analysts that are primarily responsible for the preparation of the substance of a research report.

The Commission notes that neither the current nor proposed SRO rules prohibit the consideration of the revenues or results of the firm as a whole in determining research analyst compensation. [52] The NASD has recognized that a research analyst, as part of his or her professional duties, may advise his or her firm's investment banking department concerning certain matters, such as whether a potential underwriting client is prepared for an initial public offering.[53] Therefore, for example, NASD has stated that such activities may be considered in determining an analyst's compensation; however, it may not be given undue weight relative to evaluating the quality of other research work product.[54]

The Commission believes that the proposed compensation committee amendments are consistent with the SOA and promote the alignment of investor interests with those of research analysts who are primarily responsible for the preparation of the content of research reports by requiring that the committee, in reviewing and approving research analyst compensation, consider the quality of the research product and the correlation between the research analyst's recommendations and the stock price performance. The Commission also believes that the proposed prohibition on investment banking input regarding the compensatory evaluation of all research analysts is an important restriction in reducing the influence of investment banking interests on research analysts, and satisfies the mandates of Section 15D of the Exchange Act. The Commission also finds that the amendments relating to research analyst compensation are consistent with the Exchange Act, including Sections 6(b)(5), 6(b)(8), 15A(b)(6), and 15A(b)(9).

C. Definition of ''Research Report'' [NYSE Rule 472.10(2) and NASD Rule 2711(a)(8)]

Several commenters expressed concern regarding the proposals' amended definitions of ''research report.''[55] The proposals adopt the SOA definition of ''research report'' by eliminating the current definitional requirement that a research report contain a ''recommendation.'' The NASD Rule 2711 and NYSE Rule 472 contain substantially similar amended definitions of ''research report,'' defining the term as a written or electronic communication that includes an analysis of equity securities of individual companies or industries, and provides information reasonably

[40] *See* SIA May 9th letter and Sullivan letter.

[41] *Id.*

[42] *See* NYSE 472(h)(1) and NASD Response to Comments.

[43] *See* NASD Response to Comments.

[44] *Id.*

[45] *See* SIA May 9th letter and Sullivan letter.

[46] *See* SIA March 10th letter.

[47] *See* NASD Response to Comments and NYSE Amendment No. 3.

[48] *See* SIA March 10th letter.

[49] *See* NYSE Rule 472(h)(2) and NASD Rule 2711(d)(2).

[50] *See* 15 U.S.C. 78*o*–6(a)(1)(B).

[51] *See* Amendment No. 3.

[52] The SROs' rules permit consideration of firm revenues as a whole, so long as a research analyst's compensation is not based on a specific investment banking transaction, and so long as the member discloses in research reports if the research analyst received compensation that is based upon (among other factors) the member's investment banking revenues. *See* NYSE Rule 472(h)(1) and (2), and NASD Rule 2711(d)(2).

[53] *See* NASD Response to Comments.

[54] *Id.*

[55] *See* BOA letter, CSFB letter, Schwab March 20th letter, SIA March 10th letter, Stifel letter, Sullivan letter, and Wilmer March 11th letter.

sufficient upon which to base an investment decision.

While commenters acknowledge the SOA definition,[56] some nevertheless urge the SROs to interpret the SOA's definition to be a non-substantive change to the current NASD and NYSE definitions of ''research report.'' [57] One commenter, for example, believes that the SROs should interpret the SOA definition effectively to continue to require a recommendation or a ''subjective view or conclusion.''[58] Commenters argued that, otherwise, the proposed definition would be over-inclusive, encompassing many types of communications that traditionally have not been classified as research reports, including those by individuals who are not typically considered research analysts.[59] Consequently, these commenters argue that the scope of the modified definition would result in unnecessary regulation and could constrict the free flow of information to the investing public.[60]

The SROs do not believe that the commenters' suggestions are consistent with the requirements of the SOA.[61] The NASD notes that Congress adopted a definition of ''research report'' that is very similar to the current definitions of ''research report'' in NASD Rule 2711, except for the deletion of the requirement that there be a recommendation.[62] The NASD believes that they must therefore recognize the import of that distinction.[63] As such, the NASD declines to interpret the definition in a way that they would consider to be rendering a conscious Congressional act to be superfluous.[64] In this regard, the NASD notes that the Commission adopted the SOA definition of ''research report'' in Regulation AC, and declined to incorporate interpretations suggested by commenters that would continue to require a recommendation or subjective conclusion.[65]

Commenters also suggested several other measures to narrow the scope of the proposed ''research report'' definition, such as limiting the definition of ''research report'' to communications ''furnished by the firm to investors in the U.S.'' [66] The SROs believe that all research reports produced by members, irrespective of where or to whom they are distributed, should embody the same standards of integrity.[67] The NASD notes that some aspects of NASD 2711 may reflect a more restrictive policy than the terms agreed to by the many parties, including NASD, to the Global Settlement, because the purposes behind NASD Rule 2711 may differ from the objectives in seeking a resolution to an enforcement matter.[68] For this reason, the SROs decline to modify their proposals to apply only to research that relates either to a U.S. company or a non-U.S. company for which a U.S. market is the principal equity trading market as provided in the Global Settlement.[69]

Some commenters noted that Regulation AC applies only to ''covered persons,'' generally exempting from the rule, among others, those affiliates of a broker or dealer that have no officers or employees in common with the broker or dealer.[70] Commenters also requested that the SROs narrow the scope of their rules to carve out ''departments or divisions that have a sufficient level of independence from the member firm'' and are not subject to pressure from investment banking.[71]

The NASD does not believe it necessary or appropriate to adopt a ''covered persons'' definition.[72] The NASD also notes that the Commission's jurisdiction is broader than the NASD, whose jurisdiction extends only to their members.[73] As such, research produced by non-member affiliates is already excluded from the scope of SRO analyst rules, except in cases where members distribute research produced by non-member affiliates. To the extent that commenters' concerns are more specifically about the application of the rules to investment advisers, the SROs note that the Joint Memorandum, which provides members with guidance regarding the operation of the analyst rules, explains that those advisers are excluded from the definition of ''research analyst.'' [74]

Several commenters requested that the SROs restate their previous guidance set forth in their Joint Memorandum, which excluded certain communications from the definition of ''research report.'' [75] Commenters requested that the SROs exclude from the definition certain additional communications excepted by Regulation AC or the Global Settlement.

The Commission understands that the SROs intend to review existing interpretive guidance for continued applicability, and note their belief that the guidance in the Joint Memorandum excluding certain communications from the definition of ''research report'' would remain effective.[76] Moreover, the SROs have indicated agreement that certain additional categories of communications, discussed in the release adopting Regulation AC, would not fall within the amended definition of ''research report.'' [77] The SROs determined that an analysis prepared for a specific person or a limited group of fewer than fifteen persons; and periodic reports or other communications prepared for investment company shareholders or discretionary investment account clients discussing past performance or the basis for previously made discretionary investment decisions, would not fall within the definition of ''research report.''[78] The NASD continues to note that whether a particular communication falls within the definition of ''research report'' depends on specific facts and circumstances.[79]

Some commenters asserted that all ''technical analysis'' and ''quantitative'' research should be excluded from the definition of ''research report.'' [80] However, the NASD does not agree that such exclusions are appropriate beyond current interpretations.[81] Neither NASD or NYSE modified their proposals in response to this comment. The NYSE did not further elaborate on its reasoning for this determination. The Joint Memorandum excludes from the definition of ''research report''

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56 *See* 15 U.S.C. 78*o*–6(c)(2).

57 *See* SIA March 10th letter.

58 *See* Wilmer March 11th letter.

59 For example, Wilmer's June 25th comment letter, Wilmer suggested that communications such as prospectuses, trading commentary or company profiles could be deemed research reports under the proposed definition.

60 *See* ICI March 10th letter and Wilmer March 11th letter.

61 *See* NASD Response to Comments and NYSE Amendment No. 3.

62 *See* NASD Response to Comments.

63 *Id.*

64 *Id.*

65 *Id.* Regulation AC defines ''research report'' as ''a written communication (including an electronic communication) that includes an analysis of a security or an issuer and provides information reasonably sufficient upon which to base an investment decision.'' *See* Regulation AC.

66 *See* Sullivan letter.

67 *See* NASD Response to Comments and NYSE Amendment No. 3.

68 *See* NASD Response to Comments.

69 *See* NASD Response to Comments and NYSE Amendment No. 3.

70 *See* Sullivan letter.

71 *Id.*

72 *See* NASD Response to Comments.

73 *Id.*

74 *See* NYSE Information Memorandum. No. 02–26 (June 26, 2002) and NASD Notice to Members 02–39 (July 2002) (''Joint Memorandum'').

75 *See* BOA letter, Schwab June 30th letter, SIA June 26th letter, and Sullivan letter (*e.g.*, research reports commenting on trading conditions).

76 *See* NASD Response to Comments and NYSE Amendment No. 3.

77 *Id.; See* note 14 *supra.*

78 *See* NASD Response to Comments and NYSE Amendment No. 3.

79 *See* NASD Response to Comments.

80 *See* CSFB letter, Schwab March 20th letter, and SIA March 10th letter.

81 *See* NASD Response to Comments.

communications of ''technical analysis concerning the demand and supply for a sector, index or industry based on trading volume and price.'' The NASD does not believe it is consistent with the purposes of the rules to extend the exclusion to technical analysis of individual securities.[82] The NASD also notes that the Commission similarly excluded from the definition of ''research report'' in Regulation AC only sector, index, and industry technical analysis.[83] The Commission believes that the SROs' determination not to apply the exception to individual securities is reasonable.

Commenters argue that ''quantitative'' reports are based on objective criteria, such as mathematical models, and are therefore not subject to influence by virtue of a member's conflicts.[84] The NASD believes the term ''quantitative,'' as applied to research, may be vague and open to many interpretations.[85] In fact, the NASD observes that many research reports typically labeled ''quantitative'' by members have raised conflicts concerns.[86] Further, the NASD does not agree that all mathematical models are inherently ''objective.''[87] Many such models are based on subjective formulas where a person or persons selects the inputs; for example, a particular performance ratio or consensus earnings estimates. The NASD believes that such mathematical models can be manipulated to produce a particular desired result, depending on, for example, the ratios or other criteria selected, the universe of securities, and the formula employed.[88]

Consequently, the NASD does not believe it appropriate or practicable to provide for a blanket exclusion of ''quantitative research.''[89] The NASD acknowledges the possibility that certain ''quantitative models'' devised by members may effectively eliminate the role of a ''research analyst'' and sufficiently guard against any potential conflicts of interest to render them outside the definition of a ''research report;'' however, the NASD believes that such facts and circumstances are best considered on a case-by-case basis.[90]

The Commission notes that the SROs have tailored their definitions of ''research report'' to the definition of ''research report'' in the SOA and have indicated that they intend to review the exceptions to the definition provided in the Global Settlement, in order to provide additional guidance on the rules' application where appropriate.[91]

The Commission believes that the SRO amendments to the definition of the term ''research report'' are consistent with Section 15D of the Exchange Act in that they do not require that there be a ''recommendation.'' The Commission also finds that the rules relating to research analyst involvement in solicitations for investment banking business are consistent with the Exchange Act, particularly Sections 6(b)(5), 6(b)(8), 15A(b)(6), and 15A(b)(9).

D. Definition of ''Public Appearance'' [NYSE Rule 472.50 and NASD Rule 2711(a)(4)]

The SROs amended their definitions of ''public appearance'' to include print media appearances. Several commenters were critical of this provision in light of the SROs' guidance in the Joint Memorandum, which stated that research analysts should decline subsequent appearances with media outlets that previously edited out required analyst disclosures, absent assurances that the disclosures will no longer be edited out.[92] Commenters expressed concern that the rules infringed upon the editorial discretion of the media by directing analysts to decline appearances with media outlets that previously have not included the analyst disclosures.[93]

Commenters argued that the Joint Memorandum should be revised to reflect the NASD's updated guidance in the Original Notice that an analyst would not violate the rule if he or she makes the required disclosures to the print, radio or television media in good faith, even if the media outlet does not print or broadcast the information.[94] A commenter also recommended that the proposed rules be clarified to make explicit that print journalists may, in their editorial discretion, and without penalty to their publications or imposing restrictions upon access to a research analyst, decline to publish the conflict disclosures provided by the analyst.[95]

The SROs recognized that it is important that media audiences, as well as readers of research reports, receive disclosures of potential conflicts of interests.[96] In response to commenters' concerns, however, the SROs modified their guidance to state that an analyst would not violate the rule if the analyst continues to make appearances with a media outlet that has, in the past, not printed or broadcast the disclosures, so long as the analyst makes the required disclosures in good faith.[97]

In NYSE Amendment No. 2, the Exchange would require a research analyst that recommends securities in a print media interview, article prepared under his or her name, or broadcast, to prepare a record of such interview, article, or broadcast before the close of the next business day. Such record must contain pertinent information regarding the event and the required disclosures provided the media source. Further, such record must be made regardless of whether the media outlet publishes or broadcasts the required disclosures. In addition, the SROs require that the records of such interviews, articles, or broadcasts and the requisite disclosures must be maintained in a manner consistent with Rule 17a–4 of the Exchange Act.[98]

While commenters supported the NYSE's proposed interpretation, they were concerned that the new recordkeeping requirements for public appearances were impractical and failed to take into account the realties of research analysts' business and travel schedules.[99] According to the commenters, the difficulty in requiring that research analysts themselves make the required records before the close of the next business day, would result in a reduction in the number of public appearances.[100]

In response to commenters' concerns, the NYSE amended its proposal to require that the record be made within 48 hours of such interview, article or broadcast, and would permit such record to be prepared by the research analyst, legal or compliance personnel, or research department management.[101]

In Amendment No. 3, the NASD also amended its rule proposal to explicitly

[82] *Id.*

[83] *Id.*

[84] *See* CSFB letter, Schwab March 20th letter, and SIA March 10th letter.

[85] *See* NASD Response to Comments.

[86] *Id.*

[87] *Id.*

[88] *Id.*

[89] *Id.*

[90] *Id.*

[91] *See* NASD Response to Comments and NYSE Amendment No. 3.

[92] *See* Gibson letter, NAA letter, and SIA March 10th letter.

[93] *See* Bloomberg letter, Gibson letter, NAA letter, and SIA March 10th letter.

[94] *See* Gibson letter, Schwab March 20th letter, and SIA March 10th letter. *See also* Original Notice at 836.

[95] *See* Bloomberg letter.

[96] *See* NASD Rule 2711(a)(4) and NYSE Rule 472.50.

[97] *See* NASD Amendment No. 1 and NYSE Amendment No. 2.

[98] Rule 17a–4 requires that records be preserved for a period of not less than three years, the first two in an easily accessible place. 17 CFR 240.17a–4.

[99] *See* Schwab June 30th letter, SIA June 26th letter, and Wilmer June 25th letter.

[100] *See* Wilmer June 25th letter.

[101] *See* NYSE Rule 472(k)(1)/01.

require that research analysts prepare a record of the disclosures made by the research analyst in a print or broadcast media interview, newspaper article, or other public appearance.[102] These records must be made regardless of whether the media source published or broadcast the disclosures and the record must be maintained for three years. NASD has not expressly included a required period of time regarding when the record must be made.

The Commission finds that the amendments to the definition of ''public appearance'' will provide media audiences, including the print media, with useful information to better evaluate the nature and extent of a firm's relationship with a subject company. The proposed amendments to the definition of ''public appearance,'' along with the proposed recordkeeping requirements and the SROs' guidance regarding media appearances, strike an appropriate balance between addressing commenters' concerns and providing investors with important disclosure information.[103] The Commission believes that the proposed recordkeeping requirements will serve as a useful tool in promoting and monitoring the disclosure of potential conflicts of interests to investors. Therefore, the Commission finds that the proposed amendments are consistent with the Exchange Act, including Sections 6(b)(5), 6(b)(8), 15A(b)(6), and 15A(b)(9).

E. Supervisory Analyst Personal Trading Restrictions [NYSE Rule 472(e)(5) and NASD Rule 2711(g)(6)]

The original proposals would have extended the existing personal trading restrictions to include other persons: the director of research, supervisory analyst, or member of a committee who have direct influence or control with respect to the preparation of research reports or establishing or changing a rating or price target of a subject company's equity securities.

Commenters were generally critical of this proposal.[104] Commenters argued that many persons who supervise or oversee research analysts review a wide range of research reports, including, in some cases, reports on all of the subject companies covered by the member.[105] They argued that expansion of the personal trading restrictions to supervisory personnel would effectively prevent these persons from owning any equity securities except diversified investment companies. This, commenters argued, would discourage many qualified persons from acting in supervisory capacities because of the trading blackout provisions and the prohibitions on trading against current recommendations. Commenters recommended that the SROs adopt less restrictive provisions regarding supervisory personnel, such as having legal or compliance personnel review their securities holdings or pre-approve trades to ensure that there is no conflict of interest.[106] Commenters recommended that the proposals be replaced by a requirement that firms implement policies and procedures reasonably designed to ensure that the trading transactions of supervisory personnel, committee members, and others, do not create a conflict of interest between their professional responsibilities and personal trading activities.[107]

In response to commenters' concerns, the SROs modified their proposals in several respects. Rather than applying the same trading restrictions to supervisory personnel that apply to research analysts, the amended proposals would require a member's legal or compliance personnel to pre-approve all securities transactions of persons who supervise research analysts and other persons, such as the director of research or member of a committee who has direct influence or control with respect to the preparation of research reports or establishing or changing a rating or price target of a subject company's equity securities, to the extent that the transactions involve securities of subject companies covered by research analysts.[108]

The Commission believes it is appropriate for the SROs to require pre-approval of securities transactions by supervisory research analysts and certain others where the securities traded are those of companies covered by the research analysts that they supervise. The Commission believes that this approach addresses the concerns regarding a possible disincentive from holding supervisory analyst positions, while still providing for a means of monitoring the trading activity of those who have direct influence or control with respect to the preparation of the substance of research reports or the establishment or changing of a rating or price target of a company's equity securities. Therefore, the Commission finds that the proposed rules are consistent with the Exchange Act, particularly Sections 6(b)(5), 6(b)(8), 15A(b)(6), and 15A(b)(9).

F. Research Analyst Ownership Disclosure and Personal Trading Restrictions [NYSE Rule 472(k)(1)(iii)(b) and (k)(2)(i)(b) and 472(e) and NASD Rule 2711(h)(1)(A) and 2711(g)]

Commenters recommended that managed accounts not controlled by the account owner should be excepted from the trading restrictions placed on research analysts.[109] One commenter believed that NYSE Rule 472(e)(4)(v) currently seems to exempt such accounts from the trading restrictions for research analysts, while NASD Rule 2711(g)(5) does not.[110]

In several instances, both NASD and NYSE have interpreted these provisions to exclude from the personal trading restrictions so-called ''blind trusts'' of research analysts or their household members where the account owner is unaware of the account's holdings or transactions.[111] The SROs have proposed modifications to the rules in Amendment No. 3 to exclude ''blind trust'' accounts that are controlled by a person other than the research analyst or member of the research analyst's household and where neither the research analyst nor member of the research analyst's household knows of the account's investments or investment transactions.

Several commenters argued that research analysts who prepare technical and quantitative research should be treated differently under the rules because those models do not present the same conflicts concerns.[112] These commenters also asserted that the personal trading restrictions effectively bar many of these ''technical'' and ''quantitative'' research analysts from owning any stocks because the broad universe of securities they cover makes ownership impractical. As such, commenters suggested that the SROs either interpret the definition of ''research report'' to exclude ''technical analysis'' and ''quantitative research,'' or amend the research analyst trading restriction provisions to require only

[102] *See* NASD Rule 2711(h)(12).

[103] The Commission notes that Rule 17a–4(b)(4) requires that a broker-dealer shall preserve originals of all communications by the broker-dealer, including those subject to the rules of an SRO of which the broker-dealer is a member regarding communications with the public.

[104] *See* Schwab March 20th letter, SIA March 10th letter, Stifel letter, and Wilmer March 11th letter.

[105] *Id.*

[106] *See* SIA March 10th letter.

[107] *See* Schwab March 20th letter and SIA March 10th letter.

[108] *See* NYSE Rule 472(e)(5) and NASD Rule 2711(g)(6).

[109] *See* Schwab March 20th letter and SIA March 10th letter.

[110] *See* SIA March 10th letter.

[111] *See* NYSE Rule 472.40 and NASD Rule 2711(a)(6).

[112] *See* Schwab March 20th letter and SIA March 10th letter.

pre-approval and disclosure requirements for such research analysts.[113]

The SROs do not believe that it is appropriate to provide exemptions from the trading limitations for a certain class of individuals who meet the definition of ''research analyst.'' [114] The SROs further note that the current rules provide for exceptions to the trading restrictions for certain investment funds, including investments in registered diversified investment companies as defined in Section 5(b)(1) of the Investment Company Act of 1940.[115]

The SOA requires disclosure of the extent to which a research analyst has debt or equity investments in the issuer that is the subject of the research report or public appearance.[116] Current NASD Rule 2711(h)(1)(A) requires disclosure of whether the ''research analyst or a member of the research analyst's household has a financial interest in the securities of the subject company, and the nature of the financial interest (including, without limitation, whether it consists of any option, right, warrant, future, long or short position).'' [117] The Commission believes that NASD Rule 2711(h)(2), and NYSE Rule 472(k)(1) and (2), as amended, satisfy the requirements of Exchange Act 15D(b)(1).[118]

The Commission believes that the modified rule proposals reflect an appropriate compromise between addressing commenters' concerns and mitigating conflicts of interest that can arise when an analyst invests in the securities of companies the analyst covers. The Commission finds that the proposals are consistent with the Exchange Act, particularly Sections 6(b)(5), 6(b)(8), 15A(b)(6), and 15A(b)(9).

G. Termination of Coverage [NYSE Rule 472(f)(5) and NASD Rule 2711(f)(6)]

The original proposals require notification to customers when a firm withdraws research coverage of a subject company, and distributions of a final research report that includes a final recommendation or rating. The proposed rules also would require that notice of this withdrawal must be made in the same manner as the initial research coverage provided by the broker-dealer.

Several commenters expressed support for requiring firms to publish notice of withdrawal of research coverage of a company.[119] However, commenters requested clarification with respect to the meaning of the term ''withdrawal,'' and requested guidance regarding the requirement that notice of withdrawal must be made ''in the same manner as when research coverage was first initiated by the member.'' [120]

After considering commenters' concerns, the SROs filed amendments to require notice of ''termination'' of research coverage, rather than withdrawal or discontinuation. The NASD intends to provide general guidance as to what constitutes ''termination,'' and will also consider such scenarios on a case-by-case basis.[121]

The SROs also filed amendments to respond to commenters' concerns regarding the meaning of the requirement that the final notice must be ''made in the same manner'' as when research coverage was ''first initiated by the member.'' [122] After considering comments, the SROs modified the proposals to require that the member make the final research report on the subject company available using means of dissemination equivalent to those it ordinarily uses to provide the customer with its research reports on that subject company. The SROs also require that the final report must be comparable in scope and detail to prior research reports.

The rule proposals continue to require that the final report include a final recommendation or rating. However, the SROs have specified that a final recommendation or rating will not be required in cases where it is impracticable for the member to produce a comparable report (*e.g.*, if the research analyst covering the subject company has left the member, or where the member has terminated coverage on an industry or sector). In such cases, the rationale for termination will be required.

The Commission finds that the proposed amendments requiring notice of termination of coverage will provide investors with important information to better evaluate the usefulness of research, including whether the firm is no longer covering the issuer. The public may not be fully informed where a firm terminates coverage of a company without disclosing the termination to customers, and without providing customers with a final rating or recommendation, even in cases where a ratings change may have been warranted. The Commission believes that the amendments requiring notice of ''termination'' respond to commenters' concerns regarding what would constitute ''withdrawal,'' while providing investors with important information. Therefore, the Commission believes these proposals are consistent with the Exchange Act, including sections 6(b)(5), 6(b)(8), 15A(b)(6) and 15A(b)(9).

H. Quiet Periods on the Issuance of Research Reports [NYSE Rule 472(f) and NASD Rule 2711(f)]

The SOA requires establishment of periods during which brokers or dealers who have participated or are to participate in a securities offering as underwriters or dealers may not publish or otherwise distribute research reports related to such securities. [123] Current SRO rules impose quiet periods on underwriting managers and co-managers for 40 calendar days following an initial public offering and 10 calendar days following a secondary offering, but do not impose these restrictions on other members of the underwriting syndicate or selling group. In order to comply with the SOA, the SRO proposals establish a 25 calendar-day period after the ''date of the offering'' during which a member that has agreed to participate or is participating as an underwriter or dealer (other than as manager or co-manager) of an issuer's initial public offering may not publish or otherwise distribute a research report or make a public appearance regarding that issuer.[124]

Most commenters did not object to this proposed provision. One commenter, however, argued that the SOA does not require the SROs to apply the research blackout to every dealer that participates in the offering in any manner, including where the dealer has no agreement with the issuer or any underwriter to distribute the securities or to provide research about the issuer.[125]

The SROs have not modified this proposal. The NYSE notes that the 25-day prohibition effectively codifies quiet periods that exist because of the

[113] *See* CSFB letter and Schwab March 20th letter.

[114] *See* NASD Response to Comments and NYSE Amendment No. 3.

[115] *See* NYSE Rule 472(e)(4)(v) and (vi), and NASD Rule 2711(g)(5)(A) and (B); 15 U.S.C. 80a–5(b)(1).

[116] *See* 15 U.S.C. 78*o*–6(b)(1).

[117] In NYSE Amendment No. 3, the Exchange proposed to amend NYSE Rule 472(k)(1)(iii)(b) in order to require disclosure of the nature of the analyst's financial interest.

[118] 15 U.S.C. 78*o*–6(b)(1).

[119] *See* AIMR March 6th letter; NASAA letter; and SIA March 10th letter.

[120] *See* Schwab March 20th letter and SIA March 10th letter.

[121] *See* NASD Response to Comments.

[122] *See* SIA March 10th letter.

[123] *See* 15 U.S.C. 78*o*–6(a)(2).

[124] *See* NYSE 472(f)(3) and NASD 2711(f)(2). The Commission notes that the SROs have not proposed to impose a quiet period on non-managers that participate in secondary offerings.

[125] *See* Sullivan letter.

prospectus delivery requirements under Rule 174 under the Securities Act [126] pursuant to which brokers or dealers refrain from issuing research on exchange-listed or National Market System securities for 25 days after a registration statement becomes effective or bona fide public trading begins, to avoid the risk that such communications may be deemed prospectuses that do not meet the requirements of Section 10 of the Securities Act.[127]

The SRO proposals would amend the quiet period provisions in two other ways. First, the proposals would prohibit a member that has acted as a manager or co-manager of a securities offering from distributing a research report or making a public appearance concerning a subject company 15 days prior to and after the expiration, waiver, or termination of a lock-up agreement that restricts the sale of securities held by the subject company or its shareholders after the completion of a securities offering.

Commenters argued that this provision would raise difficult compliance issues, since co-managing underwriters often have no knowledge of a lead manager's waiver of a lock-up agreement.[128] Commenters also expressed concern that this provision could dissuade issuance of lock-up waivers prior to their normal expiration time.[129] One commenter suggested, as an alternative, that the SROs bar firms and their analysts from issuing research reports "for the purpose, in whole or in part, of affecting the price of the issuer's securities for the benefit of a selling shareholder." [130]

The SROs determined not to modify the proposals in this regard. The SROs believe that the concern regarding a co-managing underwriter's lack of knowledge of a lead manager's waiver of a lock-up agreement can be addressed through a provision in an underwriting agreement to require a lead or co-managing underwriter to notify the other managers or co-managers of its intention to grant such a waiver a specified number of days prior to doing so.[131] The SROs believe that such a notification would avoid the inadvertent issuance of research reports or making of public appearances within the blackout periods surrounding waivers of lock-up agreements.[132]

[126] 17 CFR 230.174.

[127] 15 U.S.C. 77j.

[128] *See* SIA March 10th letter.

[129] *Id.*

[130] *Id.*

[131] *See* NASD Response to Comments and NYSE Amendment No. 3.

[132] *Id.*

Several commenters requested that the blackout period regarding lock-up agreements not apply to the publication of research reports pursuant to Securities Act Rule 139 [133] regarding a subject company with "actively traded securities," as defined in SEC Regulation M,[134] or to public appearances regarding such companies.[135] These commenters noted that, because the quiet period following secondary offerings does not apply to these types of companies, the quiet period surrounding waivers or expirations of a lock-up agreement also should not apply.

After consideration of commenters' concerns, the SROs modified their proposals to apply the exception for actively traded securities to the provisions prohibiting "booster shot" research reports. The SROs note that such an exception would not be appropriate in the context of an IPO, where there is not a developed secondary trading market or widespread research coverage.[136] The SROs agree that, for certain seasoned issuers and actively traded securities, the proposed blackout surrounding the expiration of lock-up agreements is not necessary.[137] Accordingly, the SROs have amended this provision to provide for such an exception.

Second, the SRO proposals also extend the current 40 and 10-day quiet period provisions to public appearances by research analysts regarding securities that are covered by a research report blackout during the same period of time.[138] Commenters did not oppose this proposal. The SRO amendments define "date of the offering" for all quiet period provisions to mean the later of the effective date of the registration statement or the first date on which the security was bona fide offered to public.[139]

The Commission believes that the SRO rules relating to quiet periods will encourage market forces to determine the price of the security in the aftermarket following an offering unaffected by research reports and public appearances by firms with the most substantial interest in the offering—those firms that are a part of the underwriting syndicate. The Commission believes that the SROs'

[133] 17 CFR 230.139.

[134] 17 CFR 242.101(c)(1)

[135] *See* Sullivan letter.

[136] *See* NASD Response to Comments and NYSE Amendment No. 3.

[137] *Id.*

[138] *See* NYSE Rule 472(f)(1) and (2), and NASD Rule 2711(f)(1)(A) and (B).

[139] *See* NYSE Rule 472.120 and NASD Rule 2711(f)(3).

proposals to extend the current quiet period provisions to cover public appearances is a reasonable extension of the prohibition on research reports during the same period of time.

The Commission believes that the proposed 25-day quiet period provisions satisfy the requirements of Section 15D(a)(2) of the Exchange Act because they are reasonably designed to "define periods during which brokers or dealers who have participated, or are to participate, in a public offering of securities as underwriters or dealers should not publish or otherwise distribute research reports relating to such securities or to the issuer of such securities." The Commission finds that the quiet period provisions are consistent with the Exchange Act, particularly Sections 6(b)(5), 6(b)(8), 15A(b)(6) and 15A(b)(9).

I. Disclosure of Compensation and Client Arrangements [NYSE Rule 472(k) and NASD Rule 2711(h)]

The SOA requires that rules be adopted reasonably designed to require that firms disclose in research reports and public appearances any compensation received by the broker-dealer or its affiliates from the subject company that is known or should have been known by the research analyst or broker-dealer at the time the research report is issued and at the time the public appearance is made.[140]

Current SRO rules require firms to disclose investment banking compensation received from a subject company or its affiliates in the past 12 months.[141] The SROs have not proposed to change this provision. However, in NASD Amendment No. 2 and in NYSE Amendment No. 2, the SROs proposed amendments to expand the required compensation disclosures to mandate disclosure in research reports and public appearances of any non-investment banking compensation received by a member or its affiliates from the subject company. In addition, the SRO amendments would require separate disclosure of investment banking compensation and non-investment banking compensation received from the subject company or its affiliates in research report disclosures.[142]

While the SOA does not specify a look-back period for the compensation disclosure provision, the SROs proposed a 12-month retrospective

[140] *See* 15 U.S.C. 78*o*–6(b)(2).

[141] *See* NYSE Rule 472(k)(1)(i)(a)(2) and NASD Rule 2711(h)(2)(A)(ii)(b).

[142] *See* NYSE Rule 472(k)(1)(i)(a)(2) and (K)(1)(i)(d)(2), and NASD Rule 2711(h)(2)(A)(ii)(b) and (iii)(a).

period [143] to be consistent with the SOA's client disclosure provision,[144] which imposes this timeframe for disclosure of a client relationship with the subject company. In addition, the current requirement in the SRO rules for disclosure of investment banking compensation is also based on this timeframe.[145]

Several commenters were strongly critical of this proposed amendment.[146] In particular, these commenters asserted that requiring disclosure of non-investment banking compensation received by a member and its affiliates from the subject company would be extremely burdensome and complex, and therefore not in the public interest. Commenters expressed heightened concerns regarding the difficulties of tracking affiliate compensation received from the subject company. [147] They argued that real-time tracking of such compensation would be unduly burdensome and asserted that firms would be unable to implement a real-time tracking system capable of 100% accuracy with regard to disclosure of affiliate compensation.[148] Commenters argued that the SRO proposals did not give effect to the SOA requirements that the mandated rules be ''reasonably designed to address conflicts of interest,'' and would provide little useful information to investors.[149] Commenters recommended that the SROs adopt a narrower version of this proposal that would tie disclosure of the receipt of compensation by a member or its affiliates from a subject company to the research analyst's knowledge of such compensation.[150]

As noted by commenters, the SOA mandates disclosure of conflicts of interests that are ''known or should have been known'' [151] by the analyst or broker or dealer, and the SROs agree that the proposals should be modified to reflect this qualification.[152] Accordingly, the SROs revised their proposals in several respects regarding the disclosure of non-investment banking compensation received by the member or affiliates from the subject company.

While the original proposals implied that ''real-time'' disclosure was required, the modified proposals provide for periodic disclosure in certain circumstances. For example, if the member received any non-investment banking compensation from the subject company, the proposals require disclosure as of the end of the month immediately preceding the date of publication of the research report. Real time disclosure would only be required if the analyst or an employee of the member with the ability to influence the substance of the research report (''influential employee'') possesses actual knowledge of such member non investment banking compensation.[153]

The SROs revised their proposals to require disclosure in research reports of affiliate non-investment banking compensation of which the analyst or influential employee knows,[154] or of which the analyst or member or has reason to know.[155]

The modified SRO proposals respond to commenters' concerns by requiring disclosure in research reports of affiliate non-investment banking compensation of which the analyst or member ''has reason to know.''[156] The proposals create two mechanisms by which analysts and members may satisfy the disclosure requirements relating to what the analyst or member would have reason to know about affiliate non-investment banking compensation.[157]

The rules provide that this disclosure requirement will be deemed satisfied if the member has taken steps reasonably designed to identify affiliate non-investment banking compensation during that calendar quarter and discloses such in research reports within 30 days after completion of the last calendar quarter.[158] In the alternative, the proposals provide that a member and analyst would be presumed not to have a reason to know of affiliate non-investment banking compensation from the subject company, if the member maintains and enforces policies and procedures reasonably designed to prevent the analyst and any influential employee from, directly or indirectly, receiving information from the affiliate concerning whether the affiliate received such compensation.[159] If such procedures are maintained and enforced by the member, then the member and analyst would be presumed not to have reason to know of affiliate non-investment banking compensation. However, because this is a presumption of a lack of knowledge, to the extent that the research analyst or an employee of the member with the ability to influence the substance of a research report obtains actual knowledge of affiliate non-investment banking compensation, disclosure would be required under NASD Rule 2711(h)(2)(A)(iv) and NYSE Rule 472(k)(1)(ii)(b)(2).

Unlike the original proposals, which required absolute disclosure of any compensation received by the member and its affiliates, the revised proposals would limit certain of the disclosure requirements to the actual knowledge of research analysts and influential employees, and in cases where the analyst or member has reason to know. Thus, real-time tracking by the member non-investment banking compensation may not be necessary.

Commenters have argued that all of the compensation disclosure requirements should be tied to the knowledge of the research analyst or supervisor.[160] However, the SROs do not agree.[161] Certain of the disclosure requirements, such as the receipt of investment banking compensation to the member or its affiliates from the subject company, are not tied to the knowledge of specific individuals, but require that the firm track the receipt of such compensation sufficient to make affirmative disclosures where warranted.[162] The SOA also requires that disclosure of firm and affiliate compensation be made by research analysts in public appearances.[163] Therefore, the SRO proposals require the disclosure of any compensation

[143] *See* NYSE Rule 472(k)(1)(i)(d)(2) and NASD Rule 2711(h)(2)(A)(iii)(a).

[144] *See* 15 U.S.C. 78*o*–6(b)(3).

[145] *See* NYSE Rule 472(k)(1)(i)(a)(2) and NASD Rule 2711(h)(2)(A)(ii)(b).

[146] *See* BOA letter, Schwab June 30th letter, SIA June 26th letter, and Wilmer June 25th letter.

[147] *See* BOA letter and Wilmer June 25th letter.

[148] The Commission notes that, in requiring disclosure of any compensation, the SOA did not mandate, and the SRO proposals do not require, that broker-dealers disclose how much compensation was received, but rather requires affirmative disclosure (if such is the case) of whether any compensation has been received.

[149] *See* SIA June 26th letter and Wilmer June 25th letter.

[150] *Id.*

[151] The SROs use ''have reason to know'' in their proposals, because that language appears in other related rules. However, the SROs interpret ''have reason to know'' as having the same meaning as ''should have been known'' as used in the Section 501(b) of the SOA. 17 U.S.C. 78*o*–6(b). *See* NASD Response to Comments and NYSE Amendment No. 3.

[152] *See* NASD Response to Comments and NYSE Amendment No. 3.

[153] *See* NYSE Rule 472(k)(1)(i)(d)(2) and (k)(1)(ii)(b)(2), and NASD Rule 2711(h)(2)(A)(iii)(a).

[154] *See* NYSE Rule 472(k)(1)(ii)(b)(2) and NASD Rule 2711(h)(2)(A)(iv).

[155] *See* NYSE Rule 472(k)(1)(iii)(a) and NASD Rule 2711(h)(2)(A)(v).

[156] *See* NYSE Rule 472(k)(1)(ii)(b)(2) and NASD Rule 2711(h)(2)(A)(v).

[157] *See* NYSE Rule 472(k)(1)(iii)(a)(1) and (2), and NASD Rule 2711(h)(2)(a)(v)(a) and (b).

[158] *See* NYSE Rule 472(k)(1)(iii)(a)(1) and NASD Rule 2711(h)(2)(a)(v)(a).

[159] *See* NYSE Rule 472(k)(1)(iii)(a)(2) and NASD Rule 2711(h)(2)(a)(v)(b).

[160] *See* SIA June 26th letter and Wilmer June 25th letter.

[161] *See* NASD Response to Comments and NYSE Amendment No. 3.

[162] This requirement is part of the original amendments. *See* NYSE Rule 472(k)(1)(i)(a)(2) and (3), and NASD Rule 2711(h)(2)(A)(ii)(b) and (c).

[163] *See* 15 U.S.C. 78*o*–6(b).

received by the member and affiliates to be disclosed in public appearances, to the extent that the analyst knows or has reason to know of such compensation in the past 12 months.[164] This requirement, unlike current SRO rules, mandates disclosure of investment banking compensation in public appearances.[165]

The SOA mandates the establishment of rules that require disclosure of whether a subject company currently is, or was, a client of the broker or dealer during the 1-year period preceding the appearance or date of distribution of the research report, and if so, a statement of the type of services provided to the client.[166] This is broader than the current SRO rules which require a research analyst to disclose during a public appearance (when such research analyst knows or has reason to know) if the subject company is an investment banking services client of the member.[167]

In order to meet the mandates of the SOA, the proposed SRO amendments would provide for disclosure by a member in research reports, and by a research analyst during a public appearance (if the analyst knows or has reason to know), of whether a subject company is a client of the member and the types of services provided to the client.[168] The types of services have been categorized into: Investment banking services (which are required to be disclosed under current SRO rules); non-investment banking securities-related services; and non-securities services.[169]

Commenters expressed concerns regarding the client disclosure provisions that were similar to those noted above regarding the compensation disclosure provisions.[170] Commenters suggested that the client disclosure provision should be amended to require broker-dealers to disclose only those services most likely to present an actual or potential conflict of interest.[171]

Commenters also requested guidance as to what would constitute a client relationship.[172] In response to commenters' concerns, the SROs have clarified that a subject company is a client of the member if they have received compensation from the subject company, or if the member has entered into an agreement to provide services.[173]

Commenters argued that the proposals should be modified to require broker-dealers to provide disclosures regarding services provided to subject companies on an annual basis, and should be linked to the receipt of compensation for non-investment banking, securities-related, or non-securities services.[174]

NYSE believes that requiring disclosure of whether a subject company is a client and the types of services provided, including non-investment banking services, should provide investors with potentially more meaningful insight into the nature of the relationship between the subject company and the member and the potential conflicts attendant to such relationships.[175] NYSE, for example, observes that it might be more beneficial for an investor, in determining whether a firm has real conflicts of interest inherent in conducting investment banking on behalf of a subject company, to know that a member is also providing non-investment banking securities-related services to a subject company.[176]

While there is some overlap between disclosure of the receipt of compensation from a subject company and a client relationship, the SROs have declined to modify their proposals to link or merge the receipt of compensation provision to the client disclosure provision.

The SROs also modified their proposals to require disclosure of client relationships and types of services provided to the issuer, as of the end of the month immediately preceding the date of publication of the research report, or sooner, if the analyst or influential employee possess actual knowledge of such member non investment banking compensation.[177] The Commission believes this would provide firms with additional time to identify and aggregate the required information, while providing investors with relevant disclosure information and complying with the requirements of Section 15D of the Act.[178]

In requiring that firms and their research analysts identify the types of services provided to subject companies, the SROs recognize that there is a possibility that this could result in the dissemination of material non-public information.[179] This issue was raised when the Commission considered amendments to the NASD and NYSE's analyst rules in 2002.[180] The rules, approved by the Commission, require disclosure of prospective investment banking compensation.[181] In light of this concern, the SROs had structured the disclosure of information related to investment banking services to mitigate the possibility of disclosing material non-public information by requiring a general disclosure of investment banking compensation received from the subject company in the past 12 months, along with a three-month forward-looking investment banking compensation disclosure if the member ''expects to receive or intends to seek'' compensation for investment banking services from the subject company in the next three months.[182]

The SROs believe that they have also addressed concerns regarding the disclosure of material non-public information with the proposed new disclosure requirements.[183] The amendments provide for an exemption from the proposed compensation and client disclosure provisions to the extent that such disclosure would reveal material non-public information regarding specific potential future investment banking services transactions of the subject company.[184] The SOA explicitly authorized us to permit an exception for material non-public information regarding specific potential future investment banking services transactions of the subject company in the compensation disclosure provision.[185] The Commission notes that this exception applies only to *specific* potential *future* transactions of an *investment banking* nature and that relate to a particular issuer. The SROs have determined that such an exception should also apply to the client disclosure provision.[186] The Commission finds that providing for such an exception in the client disclosure provision is consistent with the SOA's compensation disclosure provision. Further, the exception as to

[164] *See* NYSE Rule 472(k)(2)(i)(c)(2) and NASD Rule 2711(h)(2)(B)(i).

[165] *Id.*

[166] *See* 15 U.S.C. 78*o*–6(b)(3).

[167] *See* NYSE Rule 472(k)(2)(i)(c)(1) and NASD Rule 2711(h)(2)(B)(iii).

[168] *See* NYSE Rule 472(k)(1)(i)(d)(1) and NASD Rule 2711(h)(2)(A)(iii)(b).

[169] *Id.*

[170] *See* SIA June 26th letter and Wilmer June 25th letter.

[171] *Id.*

[172] *See* Schwab June 30th letter and SIA June 26th letter.

[173] *See* NASD Response to Comments and NYSE Amendment No. 3.

[174] *Id.*

[175] *See* NYSE Amendment No. 3.

[176] *Id.*

[177] *See* NYSE Rule 472(k)(1)(i)(d)(1) and NASD Rule 2711(h)(2)(A)(iii)(b).

[178] *See* 15 U.S.C. 78*o*–6(b)(3).

[179] *See* NASD Response to Comments and NYSE Amendment No. 3.

[180] *See* May 2002 approval order.

[181] *Id.* at 34972.

[182] *See* NYSE Rule 472(k)(1)(i)(a)(2) and (3), and NASD Rule 2711(h)(2)(A)(ii)(b) and (c); *See also* May 2002 approval order.

[183] *See* NASD Response to Comments and NYSE Amendment No. 3.

[184] *See* NYSE Rule 472(k)(3)(i) and NASD Rule 2711(h)(2)(c).

[185] *See* 15 U.S.C. 78*o*–6(b)(2).

[186] *See* NASD Response to Comments and NYSE Amendment No. 3.

compensation is appropriate to address concerns regarding the dissemination of material non-public information regarding specific potential future investment banking services transactions of the subject company. Finally, the Commission believes that the SRO rules, by providing an exemption in the client disclosure provision fulfill the SOA mandate to adopt rules reasonably designed to provide disclosure of broker-dealers' clients and client services, while appropriately addressing concerns related to the potential dissemination of material non-public information.

In the Joint Memorandum, the SROs provided guidance that ''knows or has reason to know'' requires disclosure of such information of which the analyst has actual knowledge, as well as such information that should be reasonably discovered in the ordinary course of business. The SROs note that they expect that a research analyst would have reason to know of disclosures made in prior research reports.[187] In addition, a research analyst would have reason to know of such information by virtue of the steps taken by the member or member organization to identify compensation received by a client pursuant to proposed NYSE Rule 472(k)(1)(iii)(a)(1) and NASD Rule 2711(h)(2)(A)(v)(a).[188]

The SOA also mandates rules requiring disclosure of compensation received by a research analyst from the subject company.[189] Current SRO rules do not expressly require such disclosure. To the extent that receipt of such compensation constitutes an actual, material conflict of interest, the SROs believe that disclosure would be required under NASD Rule 2711(h)(1)(C) and NYSE Rule 472(k)(1)(iii)(d). The SROs proposed amendments specifically require disclosure of any compensation received by an analyst from the subject company in the past 12 months.[190]

The Commission believes that the proposed SRO compensation disclosure amendments are appropriate and satisfy the mandates of the SOA. Several commenters expressed concern regarding the difficulty of tracking non-investment banking compensation, especially that of member affiliates.[191] The Commission believes that the SROs have significantly modified the rule amendments from proposal in a manner that addresses commenters' concerns regarding the difficulties presented by real-time tracking of non-investment banking compensation, while meeting the requirements of the SOA. In summary, the Commission finds that the SRO rules relating to disclosure by the broker-dealer and research analyst in research reports and public appearances of broker-dealer, research analyst, and affiliate compensation from subject companies satisfy the requirements of Section 15D(b)(2) of the Exchange Act[192] in that they are reasonably designed to require each securities analyst to disclose in public appearances, and each registered broker or dealer to disclose in each research report whether any compensation has been received by the registered broker or dealer, or any affiliate thereof, including the analyst, from the issuer that is the subject of the appearance or research report, that are known or should have been known by the securities analyst or the broker or dealer, to exist at the time of the appearance or the date of distribution of the report.

The Commission also believes that the proposed provisions regarding disclosure of whether the subject company is a client of the broker-dealer and the services provided satisfy the requirements of the SOA. The Commission also finds that the proposals are consistent with the Exchange Act, including Sections 6(b)(5), 6(b)(8), 15A(b)(6) and 15A(b)(9).

J. Registration and Continuing Education Requirements [NYSE 344 and 345A; NASD 1050 and 1120]

The proposed amendments would mandate certain registration requirements for research analysts who are primarily responsible for the preparation of the substance of research reports. The proposals would impose both the regulatory element and the firm element of the continuing education requirements on research analysts.[193]

Commenters expressed several concerns with this proposal. First, commenters requested clarification that the registration and qualification requirements apply only to research analysts who are primarily responsible for the substance of a research report.[194] Second, commenters recommended that research analysts who have a certain level of industry experience, or who have already attained a commonly used industry qualification, be exempt from the qualification examinations.[195] Commenters also argued that research analysts who work for members that are not engaged in investment banking activities should be exempt from the proposed requirements.[196]

In response to these comments, the SROs modified their proposals so that the registration and qualification requirements apply only to research analysts who are primarily responsible for the preparation of the substance of research reports or whose name appears on research reports; therefore, junior analysts would not be required to register. The SROs are also considering whether there are certain classes of research analysts, who otherwise would be required to comply, that should be exempted from portions of the qualification requirements.[197] However, because the qualification examination will cover, in part, the provisions of NASD Rule 2711 and the research analyst provisions of NYSE Rule 472, the NASD has indicated that it is unlikely that any current research analysts will be wholly exempt from all parts of the qualification examination.[198] The SROs are also considering whether they will accept, as a substitute, other industry qualification exams in place of the new research analyst qualification exam.[199]

Commenters also noted that the NASD and the NYSE proposals differed as to whether the regulatory element component of their continuing education requirements applies to research analysts.[200] After further consideration, the SROs have agreed that research analysts should be required to complete both the regulatory element and the firm element of the continuing education requirements.[201] The NYSE has modified its proposals accordingly.

The Commission finds that these proposals are consistent with the Exchange Act, particularly Sections 6(b)(5), 6(b)(8), 15A(b)(6) and 15A(b)(9).

K. Retaliation [NYSE Rule 472(g)(2) and NASD Rule 2711(j)]

The SOA mandates the establishment of rules that prohibit broker-dealers engaged in investment banking activities from directly or indirectly

[187] *Id.*

[188] *Id.*

[189] *See* 15 U.S.C. 78*o*–6(b)(2).

[190] *See* NYSE Rule 472(k)(2)(ii)(a)(1) and NASD Rule 2711(h)(2)(A)(i)(b).

[191] *See* BOA letter, SIA June 26th letter, and Wilmer June 25th letter.

[192] 15 U.S.C. 78*o*–6(b)(2).

[193] *See* note 15 supra.

[194] *See* SIA March 10th letter.

[195] *See* AIMR March 6th letter, Schwab March 20th letter, and SIA March 10th letter.

[196] *See* Investorside letter.

[197] *See* NASD Response to Comments and NYSE Amendment No. 3.

[198] *See* NASD Response to Comments.

[199] *See* NASD Response to Comments and NYSE Amendment No. 3.

[200] *See* SIA March 10th letter.

[201] *See* NASD Response to Comments and NYSE Amendment No. 3.

retaliating, or threatening to retaliate, against a research analyst who publishes an adverse, negative, or otherwise unfavorable research report research report that may adversely affect the broker-dealer's present or prospective investment banking relationship.[202] The SOA specifies that the rules may not limit the authority of a broker-dealer to discipline an analyst for causes other than such research report in accordance with the policies and procedures of the firm. The SROs have extended the anti-retaliation provisions to cover public appearances and have clarified that the rule would not preclude termination of a research analyst for causes unrelated to issuing or distributing adverse research or for making an unfavorable public appearance regarding a current or potential investment-banking relationship.

Commenters did not oppose this provision. The Commission believes that the SRO proposals are designed to protect the objectivity and independence of research analysts, and meet the requirements of Section 15D of the Exchange Act, which requires that a rule be adopted that prohibits broker-dealers engaged in investment banking activities from, directly or indirectly retaliating or threatening to retaliate, against a research analyst who publishes a negative, adverse, or otherwise unfavorable research report that may adversely affect the broker-dealer's present or prospective investment banking relationship with an issuer. The Commission further believes that the SROs' determination to apply the retaliation provision to cover adverse statements made in public appearances is consistent with Sections 6(b)(5), 6(b)(8), 15A(b)(6) and 15A(b)(9).

L. Small Firm Exemption [NYSE Rule 472(m) and NASD Rule 2711(k)]

The SROs have proposed an exemption from certain of the requirements that legal or compliance personnel must act as intermediaries regarding communications for firms that engage in limited underwriting activity.[203] Current NASD Rule 2711(b)(1) and (3) and current NYSE Rule 472(b)(1) and (3), the gatekeeper provisions, prohibit a research analyst from being subject to the supervision or control of any employee of a member's investment banking department, and further require legal or compliance personnel to intermediate certain communications between the research department and non-research personnel.

As the Commission noted in the May 2002 approval order when the Commission approved these gatekeeper provisions, several commenters argued that they would impose significant costs, especially for smaller firms that would have to hire additional personnel. Commenters said that personnel in smaller firms often perform multiple functions, and therefore the separation rules impose a greater burden on these firms. These comments raised the prospect that the rules might force some firms to curtail their research, potentially reducing research coverage for smaller companies and companies of regional or local interest.

To temporarily address those concerns while the SROs considered whether an exemption was appropriate, the effectiveness of the gatekeeper provisions was delayed until July 30, 2003, or until a superseding permanent exemption is approved and becomes effective, for those members that over the previous three years, on average per year, have participated in 10 or fewer investment banking transactions or underwritings as manager or co-manager and generated $5 million or less in gross investment banking services revenues from those transactions (''small firms'').[204] The rules approved today create a permanent exemption from the gatekeeper provisions for small firms, and supersede the temporary exemption filed by the SROs in May 2003.[205]

However, the permanent exemptions for small firms, unlike the temporary exemptions, do not apply to NASD Rule 2711(c) and NYSE Rule 472(b)(4), which restrict communications between the research department and the issuer, because the SROs do not believe that it would be appropriate to provide for a permanent exception from the gatekeeper provisions for the voluntary submission of sections of a draft research report to a subject company for the purpose of checking the factual accuracy of the draft report.[206] In addition, for the purposes of the small firm exception computations, the SROs have determined that ''investment banking services'' shall not include municipal securities transactions.[207]

The SRO proposals also require members that qualify for this exemption to maintain records for three years of any communication that otherwise would be subject to the review and monitoring provisions of NASD Rule 2711(b)(3) and NYSE Rule 472(b)(1), (2), and (3).

The Commission finds that the exceptions for small firms from certain of the rules addressing the relationships between research, investment banking, and companies that are the subject of research reports, are appropriate to address concerns unique to smaller firms who may share supervisory personnel across different offices or departments. The Commission finds that the proposals are consistent with the Exchange Act, particularly Sections 6(b)(5), 6(b)(8), 15A(b)(6), and 15A(b)(9).

M. Implementation

Commenters requested that the SROs coordinate the effective dates of their proposed changes and ensure that firms have adequate time to implement new rules.[208] In response to comments, the SROs decided upon the following implementation schedule for the proposed amendments (all time periods run from the date that the Commission approves the filings) in order to provide reasonable time periods for members and member organizations to develop and implement policies, procedures and systems to comply with the new requirements:

NYSE suggests the following effective dates for the provisions contained in SR–NYSE–2002–49:

Firm and Affiliate Compensation Disclosure Provisions—(NYSE Rules 472(k)(1)(i)d.2. and (k)(1)(iii)a.)—180 days, except upon written request to the Exchange for an extension of up to an additional 90 days thereafter.

Analyst and Firm Compensation Disclosure Provisions—(NYSE Rules 472(k)(1)(ii)a., (k)(1)(iii)a., (k)(2)(i)c.2. and f.)—180 days, except upon written request to the Exchange for an extension of up to an additional 90 days thereafter.

Client Disclosure Provisions—(NYSE Rules 472(k)(1)(i)d.1, (k)(1)(ii)b.1. and (K)(2)(1)c.1)—180 days, except upon written request to the Exchange for an extension of up to an additional 90 days thereafter.

Exceptions to Disclosures Required In Rule 472(k)(1) and (2)—(NYSE Rule 472(k)(3)(1)):

As applied to disclosures under Rule 472(k)(1)((i)a.,2., and 3.; effective immediately.[209]

[202] *See* 15 U.S.C. 78*o*–6(1)(C).

[203] *See* NYSE Rule 472(b) and NASD Rule 2711(b).

[204] *See* Securities Exchange Act Release No. 47876 (May 15, 2003); *see also* Securities Exchange Act Release No. 46165 (July 3, 2002), 67 FR 46555 (July 15, 2002).

[205] *See* NYSE Rule 472(m) and NASD Rule 2711(k).

[206] *Id.*

[207] NYSE notes its belief that municipal securities underwritings are not subject to the same potential conflicts of interest as equity securities. *See* NYSE Amendment No. 3.

[208] *See* SIA March 10th letter.

[209] NYSE notes the disclosures required pursuant to Rule 472(k)(1) and (2), approved as part of the original amendments have been renumbered as part of Amendment No. 3 and remain in effect. *See* NYSE Amendment No. 3.

As applied to disclosures under Rules 472(k)(1)(i)d.1., (k)(1)(ii)b.1., and (k)(2)(i)c.—180 days.

Qualification, Examination, and Registration Requirement for Research Analysts (NYSE Rule 344)—365 days after the completion of Qualification Examination (180 days after approval to develop and implement examination).

Continuing Education Requirement for Research Analyst—(Exchange Rule 345A)—Firm Element—180 days. Regulatory Element—In accordance with industry rules and regulations upon registration/qualification of research analysts.

Compensation Committee Review/Procedures (NYSE Rule 472(h)(2)—90 days.

Anti-Retaliation and Small Firm Exemption Provisions—(NYSE Rules 472(g)(2) and 472(m))—effective immediately upon approval.

All other Rule provisions—60 days.

NASD suggests the following effective dates for the provisions contained in SR–NASD–2002–154:

Qualification, examination, registration and continuing education requirements for research analysts (proposed new Rule 1050 and proposed amendments to Rule 1120): 180 days or such longer period as determined by NASD.

New compensation and client disclosure provisions (proposed Rule 2711(h)(2)): 180 days, plus up to an additional 90 days as deemed appropriate on a case-by-case basis.

Rule 2711(h)(2)(C)—Exemption from Disclosure Requirements:

As applied to disclosures under Rules 2711(h)(2)(A)(ii)(a) and (b): Immediate upon SEC approval of the rule change

As applied to disclosures under Rule 2711(h)(2)(A)(iii)(b), (h)(2)(B)(i) and (iii): 180 days

Research analyst compensation review procedures (proposed Rule 2711(d)(2)): 90 days.

Prohibition against retaliation against research analysts (proposed Rule 2711(j)): immediately.

Exceptions for small firms (proposed Rule 2711(k)): immediately.

All other proposed rule changes: 60 days.

The Commission believes that the above implementation schedule suggested by the SROs is reasonable.

IV. Accelerated Approval of Amendments; Solicitation of Comments

The Commission find good cause to approve NYSE Amendment No. 3 and NASD Amendment No. 3 to the proposed rule changes prior to the thirtieth day after the date of publication of notice of filing of the amendments in the **Federal Register**. The original proposed rule changes and NASD Amendment No. 1 and Amendment No. 2 and NYSE Amendment No. 1 and Amendment No. 2 were published in the **Federal Register**.[210] The Commission believes that NYSE Amendment No. 3 and NASD Amendment No. 3 clarify the obligations of SRO members under the rules, refine the rules and make the NASD and NYSE proposals consistent with each other. The amendments do not contain major modifications from the scope and purpose of the rules as originally proposed, and were developed from the original proposal. Further, the majority of the modifications contained in the amendments submitted by the NASD and NYSE were made in response to comments received on the proposed rule changes. The Commission believes, moreover, that approving NYSE Amendment No. 3 and NASD Amendment No. 3 will provide greater clarity, thus furthering the public interest and the investor protection goals of the Exchange Act. Finally, the Commission also finds that it is in the public interest to approve the rules as soon as possible to expedite the implementation of the new and amended rules.

Accordingly, the Commission believes good cause exists, consistent with Sections 6(b)(5), 15A(b)(6) and 19(b) of the Exchange Act,[211] to approve NYSE Amendment No. 3 and NASD Amendment No. 3 to the proposed rule changes on an accelerated basis.

Interested persons are invited to submit written data, views, and arguments concerning NYSE Amendment No. 3 and NASD Amendment No. 3, including whether the amendments are consistent with the Exchange Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed amendments that are filed with the Commission, and all written communications relating to the amendments between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying at the Commission's Public Reference Room. Copies of such filing also will be available for inspection and copying at the principal office of the SROs.

All submissions should refer to File No. SR–NASD–2002–154 and SR–NYSE–2002–49 and should be submitted by September 3, 2003.

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Exchange Act,[212] that the proposed rule changes (SR–NASD–2002–154; SR–NYSE–2002–49), as amended, are approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[213]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 03–19730 Filed 8–1–03; 8:45 am]

BILLING CODE 8010–01–P

SMALL BUSINESS ADMINISTRATION

[Declaration of Disaster #3520]

Commonwealth of Kentucky; Amendment #2

In accordance with the notice received from the Department of Homeland Security—Federal Emergency Management Agency, effective July 25, 2003, the above numbered declaration is hereby amended to include Knox County in the Commonwealth of Kentucky as a disaster area due to damages caused by severe storms, flooding, mud and rock slides, and tornadoes beginning on June 14, 2003 and continuing through June 27, 2003.

In addition, applications for economic injury loans from small businesses located in the contiguous county of Whitley in the Commonwealth of Kentucky may be filed until the specified date at the previously designated location. All other counties contiguous to the above named primary counties have been previously declared.

All other information remains the same, *i.e.*, the deadline for filing applications for physical damage is September 2, 2003, and for economic injury the deadline is April 2, 2004.

(Catalog of Federal Domestic Assistance Program Nos. 59002 and 59008)

Dated: July 29, 2003.

Herbert L. Mitchell,

Associate Administrator for Disaster Assistance.

[FR Doc. 03–19734 Filed 8–1–03; 8:45 am]

BILLING CODE 8025–01–P

SMALL BUSINESS ADMINISTRATION

[Declaration of Disaster #3508]

Commonwealth of Kentucky; Amendment #3

In accordance with the notice received from the Department of

[210] *See* notes 5 and 7 *supra.*

[211] 15 U.S.C. 78f(b)(5), 78*o*–3(b)(6), and 78s(b).

[212] 15 U.S.C. 78s(b)(2).

[213] 17 CFR 200.30–3(a)(12).

Homeland Security—Federal Emergency Management Agency, effective July 25, 2003, the above numbered declaration is hereby amended to include Knox County in the Commonwealth of Kentucky as a disaster area due to damages caused by severe storms, flooding, mud and rock slides, and tornadoes occurring on May 4 through May 27, 2003.

In addition, applications for economic injury loans from small businesses located in the contiguous counties of Bell, Laurel and Whitley in the Commonwealth of Kentucky may be filed until the specified date at the previously designated location. All other counties contiguous to the above named primary counties have been previously declared.

All other information remains the same, *i.e.*, the deadline for filing applications for physical damage is August 4, 2003, and for economic injury the deadline is March 3, 2004.

(Catalog of Federal Domestic Assistance Program Nos. 59002 and 59008)

Dated: July 29, 2003.

Herbert L. Mitchell,

Associate Administrator for Disaster Assistance.

[FR Doc. 03–19735 Filed 8–1–03; 8:45 am]

BILLING CODE 8025–01–P

SMALL BUSINESS ADMINISTRATION

[Declaration of Economic Injury Disaster #9W54]

State of Michigan

Marquette County and the contiguous counties of Alger, Baraga, Delta, Dickinson, Iron and Menominee in the State of Michigan constitute an economic injury disaster loan area as a result of heavy rainfall and flooding which occurred May 10 through 26, 2003. The heavy rainfall and flooding caused severe economic injury to dozens of small businesses in the City of Marquette and Marquette County. Eligible small businesses and small agricultural cooperatives without credit available elsewhere may file applications for economic injury assistance as a result of this disaster until the close of business on April 29, 2004 at the address listed below or other locally announced locations:

Small Business Administration, Disaster Area 2 Office, One Baltimore Place, Suite 300, Atlanta, GA 30308.

The interest rate for eligible small businesses and small agricultural cooperatives is 2.953 percent.

The number assigned for economic injury for the State of Michigan is 9W5400.

(Catalog of Federal Domestic Assistance Program No. 59002)

Dated: July 29, 2003.

Hector V. Barreto,

Administrator.

[FR Doc. 03–19736 Filed 8–1–03; 8:45 am]

BILLING CODE 8025–01–P

DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

[Summary Notice No. PE–2003–44]

Petitions for Exemption; Summary of Petitions Received; Dispositions of Petitions Issued

AGENCY: Federal Aviation Administration (FAA), DOT.

ACTION: Notice of petitions for exemption received and of dispositions of prior petitions.

SUMMARY: Pursuant to FAA's rulemaking provisions governing the application, processing, and disposition of petitions for exemption part 11 of Title 14, Code of Federal Regulations (14 CFR), this notice contains a summary of certain petitions seeking relief from specified requirements of 14 CFR, dispositions of certain petitions previously received, and corrections. The purpose of this notice is to improve the public's awareness of, and participation in, this aspect of FAA's regulatory activities. Neither publication of this notice nor the inclusion or omission of information in the summary is intended to affect the legal status of any petition or its final disposition.

DATES: Comments on petitions received must identify the petition docket number involved and must be received on or before August 25, 2003.

ADDRESSES: You may submit comments [identified by DOT DMS Docket Number FAA–200X–XXXXX] by any of the following methods:

- Web site: *http://dms.dot.gov.* Follow the instructions for submitting comments on the DOT electronic docket site.
- Fax: 1–202–493–2251.
- Mail: Docket Management Facility; U.S. Department of Transportation, 400 Seventh Street, SW., Nassif Building, Room PL–401, Washington, DC 20590–001.
- Hand Delivery : Room PL–401 on the plaza level of the Nassif Building, 400 Seventh Street, SW., Washington, DC, between 9 a.m. and 5 p.m., Monday through Friday, except Federal Holidays.
- Federal eRulemaking Portal: Go to *http://www.regulations.gov.* Follow the online instructions for submitting comments.

Docket: For access to the docket to read background documents or comments received, go to *http://dms.dot.gov* at any time or to Room PL–401 on the plaza level of the Nassif Building, 400 Seventh Street, SW., Washington, DC, between 9 a.m. and 5 p.m., Monday through Friday, except Federal Holidays.

FOR FURTHER INFORMATION CONTACT: Tim Adams (202) 267–8033, Sandy Buchanan-Sumter (202) 267–7271, Office of Rulemaking (ARM–1), Federal Aviation Administration, 800 Independence Avenue, SW., Washington, DC 20591.

This notice is published pursuant to 14 CFR 11.85 and 11.91.

Issued in Washington, DC, on July 29, 2003.

Donald P. Byrne,

Assistant Chief Counsel for Regulations.

Petitions for Exemption

Docket No.: FAA–2003–14802.

Petitioner: Executive Airlines, Inc.

Section of 14 CFR Affected: 14 CFR 121.481, 121.487, 121.489, and 121.491.

Description of Relief Sought: To permit Executive Airlines, Inc., to conduct its operations out of San Juan, Puerto Rico, under part 121, subpart Q Flight Time Limitations and Rest Requirements: Domestic Operations (subpart Q), rather than under part 121, subpart R, Flight Time Limitations: Flag Operations (subpart R).

[FR Doc. 03–19751 Filed 8–1–03; 8:45 am]

BILLING CODE 4910–13–P

DEPARTMENT OF TRANSPORTATION

Maritime Administration

[Docket Number: 2003 15786]

Requested Administrative Waiver of the Coastwise Trade Laws

AGENCY: Maritime Administration, Department of Transportation.

ACTION: Invitation for public comments on a requested administrative waiver of the Coastwise Trade Laws for the vessel BETTY T.

SUMMARY: As authorized by Public Law 105–383 and Public Law 107–295, the Secretary of Transportation, as represented by the Maritime Administration (MARAD), is authorized to grant waivers of the U.S.-build

requirement of the coastwise laws under certain circumstances. A request for such a waiver has been received by MARAD. The vessel, and a brief description of the proposed service, is listed below. The complete application is given in DOT docket 2003–15786 at *http://dms.dot.gov*. Interested parties may comment on the effect this action may have on U.S. vessel builders or businesses in the U.S. that use U.S.-flag vessels. If MARAD determines, in accordance with Public Law 105–383 and MARAD's regulations at 46 CFR part 388 (68 FR 23084; April 30, 2003), that the issuance of the waiver will have an unduly adverse effect on a U.S.-vessel builder or a business that uses U.S.-flag vessels in that business, a waiver will not be granted. Comments should refer to the docket number of this notice and the vessel name in order for MARAD to properly consider the comments. Comments should also state the commenter's interest in the waiver application, and address the waiver criteria given in § 388.4 of MARAD's regulations at 46 CFR part 388.

DATES: Submit comments on or before September 3, 2003.

ADDRESSES: Comments should refer to docket number MARAD–2003–15786.

Written comments may be submitted by hand or by mail to the Docket Clerk, U.S. DOT Dockets, Room PL–401, Department of Transportation, 400 7th St., SW., Washington, DC 20590–0001. You may also send comments electronically via the Internet at *http://dmses.dot.gov/submit/*. All comments will become part of this docket and will be available for inspection and copying at the above address between 10 a.m. and 5 p.m., e.t., Monday through Friday, except Federal holidays. An electronic version of this document and all documents entered into this docket is available on the World Wide Web at *http://dms.dot.gov*.

FOR FURTHER INFORMATION CONTACT: Michael Hokana, U.S. Department of Transportation, Maritime Administration, MAR–830 Room 7201, 400 Seventh Street, SW., Washington, DC 20590. Telephone 202–366–0760.

SUPPLEMENTARY INFORMATION: As described by the applicant the intended service of the vessel BETTY T. is:

Intended Use: "1–3 day upscale trawler/yacht tours of Islands off the Florida Keys."

Geographic Region: "Florida Keys and vicinity."

Dated: July 28, 2003.

By order of the Maritime Administrator.

Murray Bloom,

Acting Secretary, Maritime Administration.

[FR Doc. 03–19733 Filed 8–1–03; 8:45 am]

BILLING CODE 4910–81–P

DEPARTMENT OF TRANSPORTATION

Maritime Administration

[Docket Number: MARAD 2003–15785]

Requested Administrative Waiver of the Coastwise Trade Laws

AGENCY: Maritime Administration, Department of Transportation.

ACTION: Invitation for public comments on a requested administrative waiver of the Coastwise Trade Laws for the vessel DREAM TIME.

SUMMARY: As authorized by Pub. L. 105–383 and Pub. L. 107–295, the Secretary of Transportation, as represented by the Maritime Administration (MARAD), is authorized to grant waivers of the U.S.-build requirement of the coastwise laws under certain circumstances. A request for such a waiver has been received by MARAD. The vessel, and a brief description of the proposed service, is listed below. The complete application is given in DOT docket 2003–15785 at *http://dms.dot.gov*. Interested parties may comment on the effect this action may have on U.S. vessel builders or businesses in the U.S. that use U.S.-flag vessels. If MARAD determines, in accordance with Pub. L. 105–383 and MARAD's regulations at 46 CFR part 388 (68 FR 23084; April 30, 2003), that the issuance of the waiver will have an unduly adverse effect on a U.S.-vessel builder or a business that uses U.S.-flag vessels in that business, a waiver will not be granted. Comments should refer to the docket number of this notice and the vessel name in order for MARAD to properly consider the comments. Comments should also state the commenter's interest in the waiver application, and address the waiver criteria given in § 388.4 of MARAD's regulations at 46 CFR part 388.

DATES: Submit comments on or before September 3, 2003.

ADDRESSES: Comments should refer to docket number MARAD–2003–15785.

Written comments may be submitted by hand or by mail to the Docket Clerk, U.S. DOT Dockets, Room PL–401, Department of Transportation, 400 7th St., SW., Washington, DC 20590–0001. You may also send comments electronically via the Internet at *http://dmses.dot.gov/submit/*. All comments will become part of this docket and will be available for inspection and copying at the above address between 10 a.m. and 5 p.m., e.t., Monday through Friday, except Federal holidays. An electronic version of this document and all documents entered into this docket is available on the World Wide Web at *http://dms.dot.gov*.

FOR FURTHER INFORMATION CONTACT: Michael Hokana, U.S. Department of Transportation, Maritime Administration, MAR–830 Room 7201, 400 Seventh Street, SW., Washington, DC 20590. Telephone 202–366–0760.

SUPPLEMENTARY INFORMATION: As described by the applicant the intended service of the vessel DREAM TIME is:

Intended Use: "Charters and Sail Training."

Geographic Region: "Florida and East Coast of the United States."

Dated: July 28, 2003.

By order of the Maritime Administrator.

Murray Bloom,

Acting Secretary, Maritime Administration.

[FR Doc. 03–19732 Filed 8–1–03; 8:45 am]

BILLING CODE 4910–81–P

DEPARTMENT OF TRANSPORTATION

National Highway Traffic Safety Administration

Denial of Motor Vehicle Defect Petition, DP03–005

AGENCY: National Highway Traffic Safety Administration (NHTSA), Department of Transportation.

ACTION: Denial of petition for a defect investigation.

SUMMARY: This notice sets forth the reasons for the denial of a petition submitted to NHTSA under 49 U.S.C. 30162, requesting that the agency investigate an alleged defect with respect to the brake rotors on model year (MY) 2002 Nissan Xterra vehicles. The petition is identified as DP03–005.

FOR FURTHER INFORMATION CONTACT: Mr. Jonathan White, Office of Defects Investigation (ODI), NHTSA, 400 Seventh Street, SW, Washington, DC 20590. Telephone: (202) 366–5226.

SUPPLEMENTARY INFORMATION: Mr. Kent Jones of Kernersville, NC, submitted a petition to NHTSA by e-mail dated July 1, 2003, requesting NHTSA to investigate the brake rotors on MY 2002 Nissan Xterra vehicles. The petitioner alleged that the brake rotors in these vehicles overheat and warp from normal usage (alleged defect).

A review of ODI's database for complaints regarding MY 2001 through MY 2003 Nissan Xterra vehicles identified only two reports related to brake rotor warping; one for a MY 2001 and one for a MY 2002. The complaint for the MY 2002 Nissan Xterra was reported by the petitioner.

Brake rotor warping can result in brake pulsation and shaking when the brake is applied. Brake pulsation, tire or suspension vibration, and similar conditions, while an obvious annoyance to the driver, generally do not cause a driver to lose control of a vehicle. Furthermore, even if left uncorrected, any potential increase in stopping distance will be negligible. Therefore, this condition does not normally constitute a safety defect, even if it occurs with far more frequency.

In view of the foregoing, it is unlikely that NHTSA would issue an order for the notification and remedy of an alleged safety-related defect as defined by the petitioner in MY 2002 Nissan Xterra vehicles at the conclusion of an investigation. Therefore, in view of the need to allocate and prioritize NHTSA's limited resources to best accomplish the agency's safety mission, the petition is denied.

Authority: 49 U.S.C. 30162(d); delegations of authority at CFR 1.50 and 501.8.

Issued on: July 29, 2003.

Kenneth N. Weinstein,

Associate Administrator for Enforcement.

[FR Doc. 03–19750 Filed 8–1–03; 8:45 am]

BILLING CODE 4910–59–P

DEPARTMENT OF TRANSPORTATION

Surface Transportation Board

[STB Finance Docket No. 34374]

Union Pacific Railroad Company—Temporary Trackage Rights Exemption—The Burlington Northern and Santa Fe Railway Company

The Burlington Northern and Santa Fe Railway Company (BNSF), has agreed to grant temporary overhead trackage rights to Union Pacific Railroad Company (UP) over BNSF's rail lines between BNSF milepost 117.1 near Shawnee Jct., WY, and BNSF milepost 33.8 near Northport, NE, a distance of approximately 146.2 miles.[1]

The transaction was scheduled to be consummated on July 21, 2003,[2] and the authorization was expected to expire on or about July 28, 2003. The purpose of the temporary rights was to facilitate maintenance work on UP lines.

As a condition to this exemption, any employees affected by the temporary trackage rights will be protected by the conditions imposed in *Norfolk and Western Ry. Co.—Trackage Rights–BN,* 354 I.C.C. 605 (1978), as modified in *Mendocino Coast Ry., Inc.—Lease and Operate,* 360 I.C.C. 653 (1980), *aff'd sub nom. Railway Labor Executives' Ass'n v. United States,* 675 f.2d 1248 (D.C. Cir. 1982).

This notice is filed under 49 CFR 1180.2(d)(8).[3] If it contains false or misleading information, the exemption is void *ab initio.* Petitions to revoke the exemption under 49 U.S.C. 10502(d) may be filed at any time. The filing of a petition to revoke will not automatically stay the transaction.

An original and 10 copies of all pleadings, referring to STB Finance Docket No. 34374, must be filed with the Surface Transportation Board, 1925 K Street, NW, Washington, DC 20423–0001. In addition, a copy of each pleading must be served on Robert T. Opal, 1416 Dodge St., Room 830, Omaha NE 68179.

Board decisions and notices are available on our Web site at *''www.stb.dot.gov.''*

Decided: July 29, 2003.

By the Board, David M. Konschnik, Director, Office of Proceedings.

Vernon A. Williams,

Secretary.

[FR Doc. 03–19778 Filed 8–1–03; 8:45 am]

BILLING CODE 4915–00–P

DEPARTMENT OF THE TREASURY

Submission for OMB Review; Comment Request

July 25, 2003.

The Department of Treasury has submitted the following public information collection requirement(s) to OMB for review and clearance under the Paperwork Reduction Act of 1995, Public Law 104–13. Copies of the submission(s) may be obtained by calling the Treasury Bureau Clearance Officer listed. Comments regarding this information collection should be addressed to the OMB reviewer listed and to the Treasury Department Clearance Officer, Department of the Treasury, Room 11000, 1750 Pennsylvania Avenue, NW., Washington, DC 20220.

DATES: Written comments should be received on or before September 3, 2003 to be assured of consideration.

Internal Revenue Service (IRS)

OMB Number: 1545–0217.

Form Number: IRS Form 5735 and Schedule P.

Type of Review: Revision.

Title: Possessions Corporation Tax Credit (Under Sections 936 and 30A) (5735); and Allocation of Income and Expenses Under Section 936(h)(5) (Schedule P).

Description: Form 5735 is used to compute the possessions tax credit under sections 936 & 30A. Schedule P is used by corporations that elect to share the income or expenses with their affiliates. Each form provides the IRS with information to determine if the corporations have correctly computed the tax credit and the cost-sharing or profit-split method.

Respondents: Business or other for-profit.

Estimated Number of Respondents/Recordkeepers: 1,371.

Estimated Burden Hours Per Respondent/Recordkeeper:

	Form 5735	Schedule P
Recordkeeping	20 hr., 5 min.	9 hr., 48 min.
Learning about the law or the form	4 hr., 48 min.	1 hr., 27 min.
Preparing the form	7 hr., 12 min.	2 hr., 36 min.
Copying, assembling, and sending the form to the IRS	32 min.	16 min.

[1] The trackage rights involve BNSF subdivisions with non-contiguous mileposts. Therefore, total mileage does not correspond to the milepost designations of the endpoints.

[2] The notice was filed with the Board on July 15, 2003. Accordingly, the earliest the transaction could be consummated was July 22, 2003 (7 days after filing under 49 CFR 1180.4(g)).

[3] The Board adopted a new class exemption for trackage rights that, by their terms, are for overhead operations only and expire on a date certain, not to exceed 1 year from the effective date of the exemption. *See Railroad Consolidation Procedures—Exemption for Temporary Trackage Rights,* STB Ex Parte No. 282 (Sub-No. 20) (STB served May 23, 2003).

Frequency of Response: Annually.

Estimated Total Reporting/ Recordkeeping Burden: 33,818 hours.

Clearance Officer: Glenn Kirkland (202) 622–3428, Internal Revenue Service, Room 6411–03, 1111 Constitution Avenue, NW., Washington, DC 20224.

OMB Reviewer: Joseph F. Lackey, Jr. (202) 395–7316, Office of Management and Budget, Room 10235, New Executive Office Building, Washington, DC 20503.

Mary A. Able,

Departmental Reports Management Officer.

[FR Doc. 03–19707 Filed 8–1–03; 8:45 am]

BILLING CODE 4830–01–P

DEPARTMENT OF VETERANS AFFAIRS

Capital Asset Realignment for Enhanced Services (CARES) Commission; Notice of Public Hearings

The Department of Veterans Affairs (VA) gives notice under Public Law 92–463 (Federal Advisory Committee Act) that the Capital Asset Realignment for Enhanced Services (CARES) Commission will be holding public hearings on the impact of the CARES draft national plan in the Veterans Integrated Services Networks (VISN) and Markets designated below. The hearings will be conducted at the locations, dates and times as follows:

Dates	VA sites	Hearing locations	Markets	VISN
August 12, 9:00 a.m.	Baltimore, MD	Marriott (Waterfront) Hotel, 700 Aliceanna Street, Baltimore, MD 21202.	All Markets	5
August 12, 9:00 a.m.	Cleveland, OH	Intercontinental Hotel and Conference Center, Amphitheatre A and B, 9801 Carnegie Avenue, Cleveland, OH 44106.	Eastern	10
August 18, 9:00 a.m.	Leavenworth, KS	Leavenworth VA Medical Center Theatre, 4101 4th Street Trafficway, Leavenworth, KS 64068.	Central West	15
August 19, 9:00 a.m.	Columbus, OH	Franklin County Veterans Memorial, 300 W. Broad Street, Auditorium, Columbus, OH 43215.	Central Western	10
August 20, 1:00 a.m.	Fort Wayne, IN	Indiana Wesleyan University Conference Center, 8211 Jefferson Boulevard, Ft. Wayne, IN 46804.	Indiana Central Illinois	11
August 20, 9:00 a.m.	Poplar Bluff, MO	Black River Coliseum, 301 South 5th Street, Poplar Bluff, MO 63901.	East	15
August 22, 9:00 a.m.	Detroit, MI	John D. Dingell VA Medical Center, 4646 John R Street, Room B–1290, Detroit, MI 48201.	Michigan	11
August 22, 9:00 a.m.	Muskogee, OK	Muskogee VA Medical Center Auditorium, 1011 Honor Heights Drive, Muskogee, OK 74401.	Upper Western	16
August 25, 10:00 a.m.	Bedford, MA	Wyndham Billerica Hotel, 270 Concord Road, Billerica, MA 01862.	All Markets	1
August 26, 10:00 a.m.	Biloxi, MS	Va Gulf Coast Veterans Health Care System, Recreation Hall Building 17, 400 Veterans Avenue, Biloxi, MS 39531.	Central Southern Eastern Southern	16
August 27, 10:00 a.m.	Pittsburgh, PA	VA Pittsburgh Healthcare System, Highland Drive Division, 7180 Highland Drive, Pittsburgh, PA 15206.	Western	4
August 27, 1:00 p.m.	Shreveport, LA	Shreveport VA Medical Center, Education Center, 510 E. Stoner Avenue, Shreveport, LA 71101.	Central Lower	16
August 28, 10:00 a.m.	Coatesville, PA	VA Medical Center, 1400 Blackhorse Hill Road, Coatesville, PA 19320.	Eastern	4
August 28, 1:00 p.m.	Atlanta, GA	VA Medical Center, 1670 Clairmont Road, Pete Wheeler Auditorium, Room GA 104, Decatur, GA 30033.	Alabama Georgia	7
September 3, 9:00 a.m.	Minneapolis, MN	VA Medical Center, One Veterans Drive, Building 70, Room Auditorium, 1S–126, Minneapolis, MN 55417.	Minnesota N. Dakota S. Dakota	23
September 4, 1:00 p.m.	Omaha, NE	Holiday Inn Central, 3321 S. 72nd Street, Palace G, Omaha, NE 68124.	Nebraska Iowa	23
September 8, 10:00 a.m.	Charleston, SC	Elks Lodge 242, 1113 Sam Rittenberg Boulevard, Charleston, SC 29407.	South Carolina	7
September 8, 9:00 a.m.	Lexington, KY	Marriott Griffin Gate Resort, Grand Ball Room, 1800 Newtown Pike, Lexington, KY 40511.	Northern	9
September 10, 9:00 a.m.	Nashville, TN	Nashville Convention Center, 601 Commerce Street, Hearing Room 108–109, Nashville, TN 37203.	Central Eastern Western	9
September 10, 9:00 a.m.	Orlando, FL	Adam's Mark Hotel, Florida Mall, 1500 Sand Lake Road, Orlando, FL 32809.	All Markets	8
September 12, 10:00 a.m.	Durham, NC	Durham Marriott at the Civic Center, 201 Foster Street, Durham, NC 27701.	All Markets	6
September 15, 1:00 p.m.	Lyons, NJ	VA New Jersey Healthcare System (Lyons Campus), Building 143—Multipurpose Room, 151 Knollcroft Road, Lyons, NJ 07939.	New Jersey	3
September 17, 1:00 p.m.	Bronx, NY	VA Medical Center, Main Hospital—Room 3D–22 (3rd Floor), 130 West Kingsbridge Road, Bronx, NY 10468.	Long Island Metro New York	3
September 18, 9:00 a.m.	El Paso, TX	El Paso VA Health Care System, Soldiers Hall, Building 2, Fort Bliss, TX 79916.	New Mexico/West Texas	18
September 19, 1:00 p.m.	Prescott, AZ	Northern Arizona VA Healthcare System, 500 Hwy 89N, Building 15 Theatre, Prescott, AZ 86313.	Arizona	18
September 19, 1:00 p.m.	Syracuse, NY	MARX Hotel & Conference Center, 701 East Genesee Street, Syracuse, NY 13210.	All Markets	2
September 22, 1:00 p.m.	Denver, CO	VA Medical Center, 1055 Clermont Street, Denver, CO 80220.	Western Rockies Grand Junction Eastern Rockies	19
September 24, 1:00 p.m.	Billings, MT	Holiday Inn Grand Montana, 5500 Midland Road, Billings MT 59101.	Montana Wyoming Sheridan	19

Dates	VA sites	Hearing locations	Markets	VISN
September 26, 10:00 a.m.	Las Vegas, NV	Hyatt Regency Lake Las Vegas, 101 Montelago Boulevard, Henderson, NV 89011.	Nevada (South Central)	22
September 26, 9:00 a.m.	Portland, OR	VA Medical Center, Vancouver Threatre Building C–6, 1601 E. Fourth Plain Boulevard, Vancouver, WA 98661.	So. Cascade Inland South Alaska	20
September 29, 10:00 a.m.	Long Beach, CA	VA Long Beach Healthcare System, 5901 E. 7th Street, Long Beach, CA 90822.	California (Southern)	22
September 29, 9:00 a.m.	Walla Walla, WA	Jonathan M. Wainwright Memorial VA, Medical Center Theater, Building 78, 77 Wainwright Drive, Walla Walla, WA 99362.	W. Washington Inland North	20
October 1, 10:00 a.m.	Palo Alto, CA	Va Palo Alto Healthcare System, Auditorium, Building 101, 3801 Miranda Avenue, Palo Alto, CA 94304.	North Coast South Coast Pacific Island	21
October 1, 1:00 p.m.	San Antonio, TX	Henry B. Gonzales Convention Center, 200 E. Street, San Antonio, TX 78205.	South Valley Coastal Bend	17
October 2, 10:00 a.m.	Sacramento, CA	Garden Pavilion, Operated by LionsGate Hotel at McClellan Park, 5640 Dudley Boulevard, McClellan, CA 95652.	North Valley South Valley Sierra Nevada	21
October 3, 1:00 p.m.	Dallas, TX	Dallas VA Medical Center, Community Center, 4500 S. Lancaster Rd., Dallas, Texas 75216.	North Central	17

* Veterans Integrated Service Network.

The purpose of the Commission is to conduct an external assessment of VA's capital asset needs. The Commission will consider recommendations prepared for the CARES draft national plan, and the views and concerns of veterans service organizations, individual veterans, Congress, medical school affiliates, VA employees, local government entities, community groups and others. Following its assessment, the Commission will make specific recommendations to the Secretary of Veterans Affairs regarding the realignment and allocation of capital assets necessary to meet the demands for veterans health care.

Interested persons in the general public may observe the hearings and/or file written statements with the Commission regarding the impact of the draft national plan in the markets designated to be covered at each hearing. Written statements may be filed either before the hearing or within 7 days after the hearing. These statements may be addressed to Mr. Richard D. Larson, Executive Director, CARES Commission, (OOCARES), 810 Vermont Avenue, NW., Washington, DC 20480; or faxed to (202) 501–2196; or submitted electronically to *http://www.carescommission.va.gov.* Where applicable, written statements should indicate that they are submitted regarding a specific hearing. Such statements will be given a weight equal to testimony provided at the Commission hearings. Any member of the public wishing additional information should contact Ms. Janice Sloan at the Commission, at (202) 501–2000.

Dated: July 29, 2003.

By Direction of the Secretary.

E. Philip Riggin,

Committee Management Officer.

[FR Doc. 03–19759 Filed 8–1–03; 8:45 am]

BILLING CODE 8320–01–M

DEPARTMENT OF VETERANS AFFAIRS

Chiropractic Advisory Committee; Notice of Meeting

The Department of Veterans Affairs (VA) gives notice under Public Law 92–463 (Federal Advisory Committee Act) that the Chiropractic Advisory Committee will meet Tuesday, September 16, 2003, from 8:30 a.m. until 5 p.m., and Wednesday, September 17, 2003, from 8:30 a.m. until 4 p.m., at the Department of Veterans Affairs, Tech World Room 1105, 8011 I St., NW., Washington, DC 20001. The meeting is open to the public.

The purpose of the Committee is to provide direct assistance and advice to the Secretary of Veterans Affairs in the development and implementation of the chiropractic health program. Matters on which the Committee shall assist and advise the Secretary include protocols governing referrals to chiropractors and direct access to chiropractic care, scope of practice of chiropractic practitioners, definitions of services to be provided and such other matters as the Secretary determines to be appropriate.

On September 16, the Committee will receive an update on the status of the chiropractic occupational study and discuss the draft recommendations to the Secretary. On September 17, the Committee will discuss the agenda for the next meeting and continue discussions on the recommendations.

Any member of the public wishing to attend the meeting is requested to contact Ms. Sara McVicker, RN, MN, Designated Federal Officer, at (202) 273–8558, no later than noon eastern time on Friday, September 12, 2003, in order to facilitate entry to the building. No time will be allocated at this meeting for receiving oral presentations from the public.

The draft recommendations to be discussed at the meeting will be posted not later than July 29, 2003, on the Committee Internet site at *www.va.gov/primary* and will be available upon request after that date from Ms. McVicker. The Committee will accept written comments on the draft recommendations from interested parties. It is preferred that such comments be transmitted electronically to the Committee at *sara.mcvicker@mail.va.gov.* Comments may be mailed to: Chiropractic Advisory Committee, Primary and Ambulatory Care SHG (112), U.S. Department of Veterans Affairs, 810 Vermont Avenue, NW., Washington, DC 20420. Items mailed via United States Postal Service require 7–10 days for delivery due to delays resulting from security measures. Comments received prior to August 22, 2003, will be compiled for Committee review prior to the meeting. Comments received after that date but prior to the meeting will be provided to Committee members at the meeting.

Dated: July 28, 2003.

By Direction of the Secretary.

E. Phillip Riggin,

Committee Management Officer.

[FR Doc. 03–19758 Filed 8–1–03; 8:45 am]

BILLING CODE 8320–01–M

DEPARTMENT OF VETERANS AFFAIRS

Veterans' Advisory Committee on Rehabilitation (VACOR); Notice of Meeting

The Department of Veterans Affairs (VA) gives notice under Public Law 92–463 (Federal Advisory Committee Act) that a meeting of the Veterans' Advisory Committee on Rehabilitation (VACOR), will be held on September 10–12, 2003, at the Department of Veterans Affairs, Room C–7, 810 Vermont Avenue, NW., Washington, DC. The meeting sessions will begin at 8 a.m. each day and end at 4:30 p.m. on September 10 and 11 and at 12 Noon on September 12. The meeting is open to the public.

The purpose of the Committee is to provide advice to the Secretary of Veterans Affairs on the rehabilitation needs of disabled veterans and the administration of VA's rehabilitation programs.

Specifically, the Committee will be discussing the information gathered from three separate fact-finding site visits accomplished this spring to the following Department of Veterans Affairs Medical Centers: Palo Alto, California; Miami, Florida; and Dallas, Texas.

No time will be allocated at this meeting for receiving oral presentations from the public. Any member of the public wishing to attend the meeting is requested to contact Ms. Alison Rosen, Designated Federal Officer, at (202) 273–7208. The Committee will accept written comments, which should be addressed to Ms. Rosen at Department of Veterans Affairs, Veterans Benefits Administration (28), 810 Vermont Avenue, NW., Washington, DC 20420, or electronically to *VREAROSE@VBA.VA.GOV*. In their communications with the Committee, the writers must identify themselves and state the organizations, associations, or person(s) they represent.

Dated: July 28, 2003.

By Direction of the Secretary.

E. Philip Riggin,

Committee Management Officer.

[FR Doc. 03–19757 Filed 8–1–03; 8:45 am]

BILLING CODE 8320–01–M

Corrections

Federal Register

Vol. 68, No. 149

Monday, August 4, 2003

This section of the FEDERAL REGISTER contains editorial corrections of previously published Presidential, Rule, Proposed Rule, and Notice documents. These corrections are prepared by the Office of the Federal Register. Agency prepared corrections are issued as signed documents and appear in the appropriate document categories elsewhere in the issue.

ENVIRONMENTAL PROTECTION AGENCY

40 CFR Part 52

[Region II Docket No. NJ62–262, FRL–7535–4]

Approval and Promulgation of Implementation Plans; New Jersey; Revised Motor Vehicle Emissions Inventories for 1996, 2005, and 2007 and Motor Vehicle Emissions Budgets for 2005 and 2007 Using MOBILE6

Correction

In rule document 03–18853 beginning on page 43462 in the issue of Wednesday, July 23, 2003, make the following correction:

On page 43463, Table 1 is corrected as set forth below.

TABLE 1.—NEW JERSEY'S REVISED MOTOR VEHICLE EMISSIONS INVENTORIES

NAA area	2005		2007	
	VOC (tpd)	NO_X (tpd)	VOC (tpd)	NO_X (tpd)
Atlantic City	14.63	22.07	(1)	(1)
Northern New Jersey	156.37	237.17	134.00	186.93
Trenton	50.48	77.72	(1)	(1)
Allentown	5.59	12.89	4.77	10.25
State total	227.08	349.85	(1)	(1)

[1] Not applicable.

[FR Doc. C3–18853 Filed 8–1–03; 8:45 am]

BILLING CODE 1505–01–D

Monday,
August 4, 2003

Part II

Department of the Treasury

Office of the Comptroller of the Currency

12 CFR Part 3

Federal Reserve System

12 CFR Parts 208 and 225

Federal Deposit Insurance Corporation

12 CFR Part 325

Department of the Treasury

Office of Thrift Supervision

12 CFR Part 567

Risk-Based Capital Guidelines; Implementation of New Basel Capital Accord; Internal Ratings-Based Systems for Corporate Credit and Operational Risk Advanced Measurement Approaches for Regulatory Capital; Proposed Rule and Notice

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Part 3

[Docket No. 03–14]

RIN Number 1557–AC48

FEDERAL RESERVE SYSTEM

12 CFR Parts 208 and 225

[Regulations H and Y; Docket No. R–1154]

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 325

RIN 3064–AC73

DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

12 CFR Part 567

[No. 2003–27]

RIN 1550–AB56

Risk-Based Capital Guidelines; Implementation of New Basel Capital Accord

AGENCIES: Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; and Office of Thrift Supervision, Treasury.

ACTION: Advance notice of proposed rulemaking.

SUMMARY: The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (collectively, the Agencies) are setting forth for industry comment their current views on a proposed framework for implementing the New Basel Capital Accord in the United States. In particular, this advance notice of proposed rulemaking (ANPR) describes significant elements of the Advanced Internal Ratings-Based approach for credit risk and the Advanced Measurement Approaches for operational risk (together, the advanced approaches). The ANPR specifies criteria that would be used to determine banking organizations that would be required to use the advanced approaches, subject to meeting certain qualifying criteria, supervisory standards, and disclosure requirements. Other banking organizations that meet the criteria, standards, and requirements also would be eligible to use the advanced approaches. Under the advanced approaches, banking organizations would use internal estimates of certain risk components as key inputs in the determination of their regulatory capital requirements.

DATES: Comments must be received no later than November 3, 2003.

ADDRESSES: Comments should be directed to: *OCC:* Please direct your comments to: Office of the Comptroller of the Currency, 250 E Street, SW., Public Information Room, Mailstop 1–5, Washington, DC 20219, Attention: Docket No. 03–14; fax number (202) 874–4448; or Internet address: *regs.comments@occ.treas.gov.* Due to delays in paper mail delivery in the Washington area, we encourage the submission of comments by fax or e-mail whenever possible. Comments may be inspected and photocopied at the OCC's Public Information Room, 250 E Street, SW., Washington, DC. You may make an appointment to inspect comments by calling (202) 874–5043.

Board: Comments should refer to Docket No. R–1154 and may be mailed to Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551. However, because paper mail in the Washington area and at the Board of Governors is subject to delay, please consider submitting your comments by e-mail to *regs.comments@federalreserve.gov.*, or faxing them to the Office of the Secretary at (202) 452–3819 or (202) 452–3102. Members of the public may inspect comments in Room MP–500 of the Martin Building between 9 a.m. and 5 p.m. weekdays pursuant to § 261.12, except as provided by § 261.14, of the Board's Rules Regarding Availability of Information, 12 CFR 261.12 and 261.14.

FDIC: Written comments should be addressed to Robert E. Feldman, Executive Secretary, Attention: Comments, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429. Commenters are encouraged to submit comments by facsimile transmission to (202) 898–3838 or by electronic mail to *Comments@FDIC.gov.* Comments also 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 8:30 a.m. and 5 p.m. Comments may be inspected and photocopied at the FDIC's Public Information Center, Room 100, 801 17th Street, NW., Washington, DC between 9 a.m. and 4:30 p.m. on business days.

OTS: Send comments to Regulation Comments, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552, Attention: No. 2003–27. Delivery: Hand deliver comments to the 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: No. 2003–27. Facsimiles: Send facsimile transmissions to FAX Number (202) 906–6518, Attention: No. 2003–27. E-mail: Send e-mails to *regs.comments@ots.treas.gov*, Attention: No. 2003–27, and include your name and telephone number. Due to temporary disruptions in mail service in the Washington, DC area, commenters are encouraged to send comments by fax or e-mail, if possible.

FOR FURTHER INFORMATION CONTACT:

OCC: Roger Tufts, Senior Economic Advisor (202–874–4925 or *roger.tufts@occ.treas.gov)*, Tanya Smith, Senior International Advisor (202–874–4735 or *tanya.smith@occ.treas.gov*), or Ron Shimabukuro, Counsel (202–874–5090 or *ron.shimabukuro@occ.treas.gov*).

Board: Barbara Bouchard, Assistant Director (202/452–3072 or *barbara.bouchard@frb.gov*), David Adkins, Supervisory Financial Analyst (202/452–5259 or *david.adkins@frb.gov*), Division of Banking Supervision and Regulation, or Mark Van Der Weide, Counsel (202/452–2263 or *mark.vanderweide@frb.gov*), Legal Division. For users of Telecommunications Device for the Deaf (''TDD'') only, contact 202/263–4869.

FDIC: Keith Ligon, Chief (202/898–3618 or *kligon@fdic.gov*), Jason Cave, Chief (202/898–3548 or *jcave@fdic.gov*), Division of Supervision and Consumer Protection, or Michael Phillips, Counsel (202/898–3581 or *mphillips@fdic.gov*).

OTS: Michael D. Solomon, Senior Program Manager for Capital Policy (202/906–5654); David W. Riley, Project Manager (202/906–6669), Supervision Policy; or Teresa A. Scott, Counsel (Banking and Finance) (202/906–6478), Regulations and Legislation Division, Office of the Chief Counsel, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552.

SUPPLEMENTARY INFORMATION:

I. Executive Summary

A. Introduction

In the United States, banks, thrifts, and bank holding companies (banking organizations or institutions) are subject to minimum regulatory capital requirements. Specifically, U.S. banking organizations must maintain a minimum leverage ratio and two minimum risk-based ratios.[1] The current U.S. risk-based capital requirements are based on an internationally agreed framework for capital measurement that was developed by the Basel Committee on Banking Supervision (Basel Supervisors Committee or BSC) and endorsed by the G–10 Governors in 1988.[2] The international framework (1988 Accord) accomplished several important objectives. It strengthened capital levels at large, internationally active banks and fostered international consistency and coordination. The 1988 Accord also reduced disincentives for banks to hold liquid, low-risk assets. Moreover, by requiring banks to hold capital against off-balance-sheet exposures, the 1988 Accord represented a significant step forward for regulatory capital measurement.

Although the 1988 Accord has been a stabilizing force for the international banking system, the world financial system has become increasingly more complex over the past fifteen years. The BSC has been working for several years to develop a new regulatory capital framework that recognizes new developments in financial products, incorporates advances in risk measurement and management practices, and more precisely assesses capital charges in relation to risk. On April 29, 2003, the BSC released for public consultation a document entitled ''The New Basel Capital Accord'' (New Accord) that sets forth proposed revisions to the 1988 Accord. The BSC will accept industry comment on the New Accord through July 31, 2003 and expects to issue a final revised Accord by the end of 2003. The BSC expects that the New Accord would have an effective date for implementation of December 31, 2006.

Accordingly, the Agencies are soliciting comment on all aspects of this ANPR, which is based on certain proposals in the New Accord. Comments will assist the Agencies in reaching a determination on a number of issues related to how the New Accord would be proposed to be implemented in the United States. In addition, in light of the public comments submitted on the ANPR, the Agencies will seek appropriate modifications to the New Accord.

B. Overview of the New Accord

The New Accord encompasses three pillars: minimum regulatory capital requirements, supervisory review, and market discipline. Under the first pillar, a banking organization must calculate capital requirements for exposure to both credit risk and operational risk (and market risk for institutions with significant trading activity). The New Accord does not change the definition of what qualifies as regulatory capital, the minimum risk-based capital ratio, or the methodology for determining capital charges for market risk. The New Accord provides several methodologies for determining capital requirements for both credit and operational risk. For credit risk there are two general approaches; the standardized approach (essentially a package of modifications to the 1988 Accord) and the internal ratings-based (IRB) approach (which uses an institution's internal estimates of key risk drivers to derive capital requirements). Within the IRB approach there is a foundation methodology, in which certain risk component inputs are provided by supervisors and others are supplied by the institutions, and an advanced methodology (A–IRB), where institutions themselves provide more risk inputs.

The New Accord provides three methodologies for determining capital requirements for operational risk; the basic indicator approach, the standardized approach, and the advanced measurement approaches (AMA). Under the first two methodologies, capital requirements for operational risk are fixed percentages of specified, objective risk measures (for example, gross income). The AMA provides the flexibility for an institution to develop its own individualized approach for measuring operational risk, subject to supervisory oversight.

The second pillar of the New Accord, supervisory review, highlights the need for banking organizations to assess their capital adequacy positions relative to overall risk (rather than solely to the minimum capital requirement), and the need for supervisors to review and take appropriate actions in response to those assessments. The third pillar of the New Accord imposes public disclosure requirements on institutions that are intended to allow market participants to

[1] The leverage ratio measures regulatory capital as a percentage of total on-balance-sheet assets as reported in accordance with generally accepted accounting principles (GAAP) (with certain adjustments). The risk-based ratios measure regulatory capital as a percentage of both on- and off-balance-sheet credit exposures with some gross differentiation based on perceived credit risk. The Agencies' capital rules may be found at 12 CFR Part 3 (OCC), 12 CFR Parts 208 and 225 (Board), 12 CFR Part 325 (FDIC), and 12 CFR Part 567 (OTS).

[2] The BSC was established in 1974 by the central-bank governors of the Group of Ten (G–10) countries. Countries are represented on the BSC by their central bank and also by authorities with bank supervisory responsibilities. Current member countries are Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States. The 1988 Accord is described in a document entitled ''International Convergence of Capital Measurement and Capital Standards.'' This document and other documents issued by the BSC are available through the Bank for International Settlements website at www.bis.org.

assess key information about an institution's risk profile and its associated level of capital.

The Agencies do not expect the implementation of the New Accord to result in a significant decrease in aggregate capital requirements for the U.S. banking system. Individual banking organizations may, however, face increases or decreases in their minimum risk-based capital requirements because the New Accord is more risk sensitive than the 1988 Accord and the Agencies' existing risk-based capital rules (general risk-based capital rules). The Agencies will continue to analyze the potential impact of the New Accord on both systemic and individual bank capital levels.

C. Overview of U.S. Implementation

The Agencies believe that the advanced risk and capital measurement methodologies of the New Accord are the most appropriate approaches for large, internationally active banking organizations. As a result, large, internationally active banking organizations in the United States would be required to use the A–IRB approach to credit risk and the AMA to operational risk. The Agencies are proposing to identify three types of banking organizations: institutions subject to the advanced approaches on a mandatory basis (core banks); institutions not subject to the advanced approaches on a mandatory basis, but that choose voluntarily to apply those approaches (opt-in banks); and institutions that are not mandatorily subject to and do not apply the advanced approaches (general banks). Core banks would be those with total banking (and thrift) assets of $250 billion or more or total on-balance-sheet foreign exposure of $10 billion or more. Both core banks and opt-in banks (advanced approach banks) would be required to meet certain infrastructure requirements (including complying with specified supervisory standards for credit risk and operational risk) and make specified public disclosures before being able to use the advanced approaches for risk-based regulatory capital calculation purposes.[3]

General banks would continue to apply the general risk-based capital rules. Because the general risk-based capital rules include a buffer for risks not easily quantified (for example, operational risk and concentration risk), general banks would not be subject to an additional direct capital charge for operational risk.

Under this proposal, some U.S. banking organizations would use the advanced approaches while others would apply the general risk-based capital rules. As a result, the United States would have a bifurcated regulatory capital framework. That is, U.S. capital rules would provide two distinct methodologies for institutions to calculate risk-weighted assets (the denominator of the risk-based capital ratios). Under the proposed framework, all U.S. institutions would continue to calculate regulatory capital, the numerator of the risk-based capital ratios, as they do now. Importantly, U.S. banking organizations would continue to be subject to a leverage ratio requirement under existing regulations, and Prompt Corrective Action (PCA) legislation and implementing regulations would remain in effect.[4] It is recognized that in some cases, under the proposed framework, the leverage ratio would serve as the most binding regulatory capital constraint.

Implementing the capital framework described in this ANPR would raise a number of significant practical and conceptual issues about the role of economic capital calculations relative to regulatory capital requirements. The capital formulas described in this ANPR, as well as the economic capital models used by banking organizations, assume the ability to assign precisely probabilities to future credit and operational losses that might occur. The term ''economic capital'' is often used to refer to the amount of capital that should be allocated to an activity according to the results of such an exercise. For example, a banking organization might compute the amount of income, reserves, and capital that it would need to cover the 99.9th percentile of possible credit losses associated with a given type of lending. The desired degree of certainty of covering losses is related to several factors including, for example, the banking organization's target credit rating. The higher the loss percentile the institution wishes to provide protection against, the less likely the capital held by the institution would be insufficient to cover losses, and the higher would be the institution's credit rating.

While the Agencies intend to move to a framework where regulatory capital is more closely aligned to economic capital, the Agencies do not intend to place sole reliance on the results of economic capital calculations for purposes of computing minimum regulatory capital requirements. Banking organizations face risks other than credit and operational risks, and the assumed loss distributions underlying banking organizations' economic capital calculations are subject to the risk of error. Consequently, the Agencies continue to view the leverage ratio tripwires contained in existing PCA and other regulations as important components of the regulatory capital framework.

The A–IRB Approach for Credit Risk

Under the A–IRB approach for credit risk, an institution's internal assessment of key risk drivers for a particular exposure (or pool of exposures) would serve as the primary inputs in the calculation of the institution's minimum risk-based capital requirements. Formulas, or risk weight functions, specified by supervisors would use the banking organization's estimated inputs to derive a specific dollar amount capital requirement for each exposure (or pool of exposures). This dollar capital requirement would be converted into a risk-weighted assets equivalent by multiplying the dollar amount of the capital requirement by 12.5—the reciprocal of the 8 percent minimum risk-based capital requirement. Generally, banking organizations using the A–IRB approach would assign assets and off-balance-sheet exposures into one of three portfolios: wholesale (corporate, interbank, and sovereign), retail (residential mortgage, qualifying revolving, and other), and equities. There also would be specific treatments for securitization exposures and purchased receivables. Certain assets that do not constitute a direct credit exposure (for example, premises, equipment, or mortgage servicing rights) would continue to be subject to the general risk-based capital rules and risk weighted at 100 percent. A brief overview of each A–IRB portfolio follows.

Wholesale (Corporate, Interbank, and Sovereign) Exposures

Wholesale credit exposures comprise three types of exposures: corporate, interbank, and sovereign. Generally, the meaning of interbank and sovereign would be consistent with the general risk-based capital rules. Corporate exposures are exposures to private-sector companies; interbank exposures are primarily exposures to banks and securities firms; and sovereign exposures are those to central governments, central banks, and certain

[3] The Agencies continue to reserve the right to require higher minimum capital levels for individual institutions, on a case-by-case basis, if necessary to address particular circumstances.

[4] Thus, for example, to be in the well-capitalized PCA category a bank must have at least a 10 percent total risk-based capital ratio, a 6 percent Tier I risk-based capital ratio, and a 5 percent leverage ratio. The other PCA categories also would not change.

other public-sector entities (PSEs). Within the wholesale exposure category, in addition to the treatment for general corporate lending, there would be four sub-categories of specialized lending (SL). These are project finance (PF), object finance (OF), commodities finance (CF), and commercial real estate (CRE). CRE is further subdivided into low-asset-correlation CRE, and high-volatility CRE (HVCRE).

For each wholesale exposure, an institution would assign four quantitative risk drivers (inputs): (1) Probability of default (PD), which measures the likelihood that the borrower will default over a given time horizon; (2) loss given default (LGD), which measures the proportion of the exposure that will be lost if a default occurs; (3) exposure at default (EAD), which is the estimated amount owed to the institution at the time of default; and (4) maturity (M), which measures the remaining economic maturity of the exposure. Institutions generally would be able to take into account credit risk mitigation techniques (CRM), such as collateral and guarantees (subject to certain criteria), by adjusting their estimates for PD or LGD. The wholesale A–IRB risk weight function would use all four risk inputs to produce a specific capital requirement for each wholesale exposure. There would be a separate, more conservative risk weight function for certain acquisition, development, and construction loans (ADC) in the HVCRE category.

Retail Exposures

Within the retail category, three distinct risk weight functions are proposed for three product areas that exhibit different historical loss experiences and different asset correlations.[5] The three retail sub-categories would be: (1) Exposures secured by residential mortgages and related exposures; (2) qualifying revolving exposures (QRE); and (3) other retail exposures. QRE would include unsecured revolving credits (such as credit cards and overdraft lines), and other retail would include most other types of exposures to individuals, as well as certain exposures to small businesses. The key inputs to the three retail risk weight functions would be a banking organization's estimates of PD, LGD, and EAD. There would be no explicit M component to the retail A–IRB risk weight functions. Unlike wholesale exposures, for retail exposures, an institution would assign a common set of inputs (PD, LGD, and EAD) to predetermined pools of exposures, which are typically referred to as segments, rather than to individual exposures.[6] The inputs would be used in the risk weight functions to produce a capital charge for the associated pool of exposures.

Equity Exposures

Banking organizations would use a market-based internal model for determining capital requirements for equity exposures in the banking book. The internal model approach would assess capital based on an estimate of loss under extreme market conditions. Some equity exposures, such as holdings in entities whose debt obligations qualify for a zero percent risk weight, would continue to receive a zero percent risk weight under the A–IRB approach to equities. Certain other equity exposures, such as those made through a small business investment company (SBIC) under the Small Business Investment Act or a community development corporation (CDC) or a community and economic development entity (CEDE), generally would be risk weighted at 100 percent under the A–IRB approach to equities. Banking organizations that are subject to the Agencies' market risk capital rules would continue to apply those rules to assess capital against equity positions held in the trading book.[7] Banking organizations that are not subject to the market risk capital rules would treat equity positions in the trading account as if they were in the banking book.

Securitization Exposures

Under the A–IRB treatment for securitization exposures, a banking organization that originates a securitization would first calculate the A–IRB capital charge that would have been assessed against the underlying exposures as if the exposures had not been securitized. This capital charge divided by the size of the exposure pool is referred to as KIRB. If an originating banking organization retains a position in a securitization that obligates the banking organization to absorb losses up to or less than KIRB, the banking organization would deduct the retained position from capital as is currently required under the general risk-based capital rules. The general risk-based capital rules, however, require a dollar-for-dollar risk-based capital deduction for certain residual interests retained by originating banking organizations in asset securitization transactions regardless of amount. The A–IRB framework would no longer require automatic deduction of such residual interests. The amount to be deducted would be capped at KIRB for most exposures. For a position in excess of the KIRB threshold, the originating banking organization would use an external-ratings-based approach (if the position has been rated by an external rating agency or a rating can be inferred) or a supervisory formula to determine the capital charge for the position.

Non-originating banking organizations that invest in a securitization exposure generally would use an external-ratings-based approach (if the exposure has been rated by an external rating agency or a rating can be inferred). For unrated liquidity facilities that banking organizations provide to securitizations, capital requirements would be based on several factors, including the asset quality of the underlying pool and the degree to which other credit enhancements are available. These factors would be used as inputs to a supervisory formula. Under the A–IRB approach to securitization exposures, banking organizations also would be required in some cases to hold regulatory capital against securitizations of revolving exposures that have early amortization features.

Purchased Receivables

Purchased receivables, that is, those that are purchased from another institution either through a one-off transaction or as part of an ongoing program, would be subject to a two-part capital charge: one part is for the credit risk arising from the underlying receivables and the second part is for dilution risk. Dilution risk refers to the possibility that contractual amounts payable by the underlying obligors on the receivables may be reduced through future cash payments or other credits to the accounts made by the seller of the receivables. The framework for determining the capital charge for credit risk permits a purchasing organization to use a top-down (pool) approach to estimating PDs and LGDs when the

[5] Asset correlation is a measure of the tendency for the financial condition of a borrower in a banking organization's portfolio to improve or degrade at the same time as the financial condition of other borrowers in the portfolio improve or degrade.

[6] When the PD, LGD, and EAD parameters are assigned separately to individual exposures, it may be referred to as a ''bottom-up'' approach. When those parameters are assigned to predetermined sets of exposures (pools or segments), it may be referred to as a ''top-down'' approach.

[7] The market risk capital rules were implemented by the banking agencies in 1996. The market risk capital rules apply to any banking organization whose trading activity (on a consolidated worldwide basis) equals 10 percent or more of total assets, or $1 billion or more. The market risk capital rules are found at 12 CFR Part 3, Appendix B (OCC), 12 CFR Parts 208 and 225, Appendix E (Board), and 12 CFR Part 325, Appendix C (FDIC). The OTS, to date, has not adopted the market risk capital rules.

purchasing organization is unable to assign an internal risk rating to each of the purchased accounts. The capital charge for dilution risk would be calculated using the wholesale risk weight function with some additional specified risk inputs.

The AMA for Operational Risk

Under the A–IRB approach, capital charges for credit risk would be directly calibrated solely for such risk and, thus, unlike the 1988 Accord, would not implicitly include a charge for operational risk. As a result, the Agencies are proposing that banking organizations operating under the A–IRB approach also would have to hold regulatory capital for exposure to operational risk. The Agencies are proposing to define operational risk as the risk of losses resulting from inadequate or failed internal processes, people, and systems, or external events. Under the AMA, each banking organization would be able to use its own methodology for assessing exposure to operational risk, provided the methodology is comprehensive and results in a capital charge that is reflective of the operational risk experience of the organization. The operational risk exposure would be multiplied by 12.5 to determine a risk-weighted assets equivalent, which would be added to the comparable amounts for credit and market risk in the denominator of the risk-based capital ratios. The Agencies will be working closely with institutions over the next few years as operational risk measurement and management techniques continue to evolve.

Other Considerations

Boundary Issues

With the introduction of an explicit regulatory capital charge for operational risk, an issue arises about the proper treatment of losses that can be attributed to more than one risk factor. For example, where a loan defaults and the banking organization discovers that the collateral for the loan was not properly secured, the banking organization's resulting losses would be attributable to both credit and operational risk. The Agencies recognize that these types of boundary issues are important and have significant implications for how banking organizations would compile loss data sets and compute regulatory capital charges.

The Agencies are proposing the following standard to govern the boundary between credit and operational risk: A loss event that has characteristics of credit risk would be incorporated into the credit risk calculations for regulatory capital (and would not be incorporated into operational risk capital calculations). This would include credit-related fraud losses. Thus, in the above example, the loss from the loan would be attributed to credit risk (not operational risk) for regulatory capital purposes. This separation between credit and operational risk is supported by current U.S. accounting standards for the treatment of credit risks.

With regard to the boundary between the trading book and the banking book, for institutions subject to the market risk rules, positions currently subject to those rules include all positions held in the trading account consistent with GAAP. The New Accord proposed additional criteria for positions includable in the trading book for purposes of market risk capital requirements. The Agencies encourage comment on these additional criteria and whether the Agencies should consider adopting such criteria (in addition to the GAAP criteria) in defining the trading book under the Agencies' market risk capital rules. The Agencies are seeking comment on the proposed treatment of the boundaries between credit, operational, and market risk.

Supervisory Considerations

The advanced approaches introduce greater complexity to the regulatory capital framework and would require a high level of sophistication in the banking organizations that implement the advanced approaches. As a result, the Agencies propose to require core and opt-in banks to meet certain infrastructure requirements and comply with specific supervisory standards for credit risk and for operational risk. In addition, banking organizations would have to satisfy a set of public disclosure requirements as a prerequisite for approval to using the advanced approaches. Supervisory guidance for each credit risk portfolio type, as well as for operational risk, is being developed to ensure a sufficient degree of consistency within the supervisory framework, while also recognizing that internal systems will differ between banking organizations. The goal is to establish a supervisory framework within which all institutions must develop their internal systems, leaving exact details to each institution. In the case of operational risk in particular, the Agencies recognize that measurement methodologies are still evolving and flexibility is needed.

It is important to note that supervisors would not look at compliance with requirements, or standards alone. Supervisors also would evaluate whether the components of an institution's advanced approaches are consistent with the overall objective of sound risk management and measurement. An institution would have to use appropriately the advanced approaches across all material business lines, portfolios, and geographic regions. Exposures in non-significant business units as well as asset classes that are immaterial in terms of size and perceived risk profile may be exempted from the advanced approaches with supervisory approval. These immaterial portfolios would be subject to the general risk-based capital rules.

Proposed supervisory guidance for corporate credit exposures and for operational risk is provided separately from this ANPR in today's **Federal Register**. The draft supervisory guidance for corporate credit exposures is entitled ''Supervisory Guidance on Internal-Ratings-Based Systems for Corporate Credit.'' The guidance includes specified supervisory standards that an institution's internal rating system for corporate exposures would have to satisfy for the institution to be eligible to use the A–IRB approach for credit risk. The draft operational risk guidance is entitled ''Supervisory Guidance on Operational Risk Advanced Measurement Approaches for Regulatory Capital.'' The operational risk guidance includes identified supervisory standards for an institution's AMA framework for operational risk. The Agencies encourage commenters to review and comment on the draft guidance pieces in conjunction with this ANPR. The Agencies intend to issue for public comment supervisory guidance on retail credit exposures, equity exposures, and securitization exposures over the next several months.

Supervisory Review

As mentioned above, the second pillar of the New Accord focuses on supervisory review to ensure that an institution holds sufficient capital given its overall risk profile. The concepts of Pillar 2 are not new to U.S. banking organizations. U.S. institutions already are required to hold capital sufficient to meet their risk profiles, and supervisors may require that an institution hold more capital if its current levels are deficient or some element of its business practices suggest the need for more capital. The Agencies also have the right to intervene when capital levels fall to an unacceptable level. Given these long-standing elements of the U.S. supervisory framework, the Agencies are not proposing to introduce specific requirements or guidelines to implement Pillar 2. Instead, existing guidance, rules, and regulations would continue to be enforced and supplemented as necessary as part of this proposed new regulatory capital framework. However, all institutions operating under the advanced approaches would be expected by supervisors to address specific assumptions embedded in the advanced approaches (such as diversification in credit portfolios), and would be evaluated for their ability to account for deviations from the underlying assumptions in their own portfolios.

Disclosure

An integral part of the advanced approaches is enhanced public disclosure practices and improved transparency. Under the Agencies' proposal, specific disclosure requirements would be applicable to all institutions using the advanced approaches. These disclosure requirements would encompass capital, credit risk, equities, credit risk mitigation, securitization, market risk, operational risk, and interest rate risk in the banking book.

D. Competitive Considerations

It is essential that the Agencies gain a full appreciation of the possible competitive equity concerns that may be presented by the establishment of a new capital framework. The creation of a bifurcated capital framework in the United States—one set of capital standards applicable to large, internationally active banking organizations (and those that choose to apply the advanced approaches), and another set of standards applicable to all other institutions—has created concerns among some parties about the potential impact on competitive equity between the two sets of banking organizations. Similarly, differences in supervisory application of the advanced approaches (both within the United States and abroad) among large, internationally active institutions may pose competitive equity issues among such institutions.

The New Accord relies upon compliance with certain minimum operational and supervisory requirements to promote consistent interpretation and uniformity in application of the advanced approaches. Nevertheless, independent supervisory judgment will be applied on a case-by-case basis. These processes, albeit subject to detailed and explicit supervisory guidance, contain an inherent amount of subjectivity and must be assessed by supervisors on an ongoing basis. This supervisory assessment of the internal processes and controls leading to an institution's internal ratings and other estimates must maintain the high level of internal risk measurement and management processes contemplated in this ANPR.

The BSC's Accord Implementation Group (AIG), in which the Agencies play an active role, will seek to ensure that all jurisdictions uniformly apply the same high qualitative and quantitative standards to internationally active banking institutions. However, to the extent that different supervisory regimes implement these standards differently, there may be competitive dislocations. One concern is that the U.S. supervisory regime will impose greater scrutiny in its implementation standards, particularly given the extensive on-site presence of bank examiners in the United States.

Quite distinct from the need for a level playing field among internationally active institutions are the competitive concerns of those institutions that do not elect to adopt or may not qualify for the advanced approaches. Some banking organizations have expressed concerns that small or regional banks would become more likely to be acquired by larger organizations seeking to lever capital efficiencies. There also is a qualitative concern about the impact of being considered a ''second tier'' institution (one that does not implement the advanced approaches) by the market, rating agencies, or sophisticated customers such as government or municipal depositors and borrowers. Finally, there is the question of what, if any, competitive distortions might be introduced by differences in regulatory capital minimums between the advanced approaches and the general risk-based capital rules for loans or securities with otherwise similar risk characteristics, and the extent to which such distortions may be mitigated in an environment in which well-managed banking organizations continue to hold excess capital.[8]

Because the advanced framework described in this ANPR is more risk-sensitive than the 1988 Accord and the general risk-based capital rules, banking organizations under the advanced approaches would face increases in their minimum risk-based capital charges on some assets and decreases on others. The results of a Quantitative Impact Study (QIS3) the BSC conducted in late 2002 indicated the potential for the advanced approaches described in this document to produce significant changes in risk-based capital requirements for specific activities; the results also varied on an institution-by-institution basis. The results of QIS3 can be found at *http://www.bis.org* and various results of QIS3 are noted at pertinent places in this ANPR.

The Agencies do not believe the results of QIS3 are sufficiently reliable to form the basis of a competitive impact analysis, both because the inputs to the study were provided on a best-efforts basis and because the proposals in this ANPR are in some cases different than those that formed the basis of QIS3. The Agencies are nevertheless interested in views on how changes in regulatory capital (for the total of credit and operational risk) of the magnitude described in QIS3, if such changes were in fact realized, would affect the competitive landscape for domestic banking organizations.

The Agencies plan to conduct at least one more QIS, and potentially other economic impact analyses, to better understand the potential impact of the proposed framework on the capital requirements for individual U.S. banking organizations and U.S. banking organizations as a whole. This may affect the Agencies' further proposals through recalibrating the A–IRB risk weight formulas and making other modifications to the proposed approaches if the capital requirements do not seem consistent with the overall risk profiles of banking organizations or safe and sound banking practices.

If competitive effects of the New Accord are determined to be significant, the Agencies would need to consider potential ways to address those effects while continuing to seek to achieve the objectives of the current proposal. Alternatives could potentially include modifications to the proposed approaches, as well as fundamentally different approaches. The Agencies recognize that an optimal capital system must strike a balance between the objectives of simplicity and regulatory consistency across banking organizations on the one hand, and the degree of risk sensitivity of the regulation on the other. There are many criteria that must be evaluated in achieving this balance, including the resulting incentives for improving risk measurement and management practices, the ease of supervisory and regulatory enforcement, the degree to

[8] The Agencies note that under the general risk-based capital rules some institutions currently are able to hold less capital than others on some types of assets (for example, through innovative financing structures or use of credit risk mitigation techniques). In addition, some institutions may hold lower amounts of capital because the market perceives them as highly diversified, while others hold higher amounts of capital because of concentrations of credit risk or other factors.

which the overall level of regulatory capital in the banking system is broadly preserved, and the effects on domestic and international competition. The Agencies are interested in commenters' views on alternatives to the advanced approaches that could achieve this balance, and in particular on alternatives that could do so without a bifurcated approach.[9]

The Agencies are committed to investigate the full scope of possible competitive impact and welcome all comments in this regard. Some questions are suggested below that may serve to focus commenters' general reactions. More specific questions also are suggested throughout this ANPR. These questions should not be viewed as limiting the Agencies' areas of interest or commenters' submissions on the proposals. The Agencies encourage commenters to provide supporting data and analysis, if available.

What are commenters' views on the relative pros and cons of a bifurcated regulatory capital framework versus a single regulatory capital framework? Would a bifurcated approach lead to an increase in industry consolidation? Why or why not? What are the competitive implications for community and mid-size regional banks? Would institutions outside of the core group be compelled for competitive reasons to opt-in to the advanced approaches? Under what circumstances might this occur and what are the implications? What are the competitive implications of continuing to operate under a regulatory capital framework that is not risk sensitive?

If regulatory minimum capital requirements declined under the advanced approaches, would the dollar amount of capital held by advanced approach banking organizations also be expected to decline? To the extent that advanced approach institutions have lower capital charges on certain assets, how probable and significant are concerns that those institutions would realize competitive benefits in terms of pricing credit, enhanced returns on equity, and potentially higher risk-based capital ratios? To what extent do similar effects already exist under the current general risk-based capital rules (for example, through securitization or other techniques that lower relative capital charges on particular assets for only some institutions)? If they do exist now, what is the evidence of competitive harm?

Apart from the approaches described in this ANPR, are there other regulatory capital approaches that are capable of ameliorating competitive concerns while at the same time achieving the goal of better matching regulatory capital to economic risks? Are there specific modifications to the proposed approaches or to the general risk-based capital rules that the Agencies should consider?

II. Application of the Advanced Approaches in the United States

By its terms, the 1988 Accord applied only to internationally active banks. Under the New Accord, the scope of application has been broadened also to encompass bank holding companies that are parents of internationally active "banking groups."

A. Threshold Criteria for Mandatory Advanced Approach Organizations

The Agencies believe that for large, internationally active U.S. institutions only the advanced approaches are appropriate. Accordingly, the Agencies intend to identify three groups of banking organizations: (1) Large, internationally active banking organizations that would be subject to the A–IRB approach and AMA on a mandatory basis (core banks); (2) organizations not subject to the advanced approaches on a mandatory basis, but that voluntarily choose to adopt those approaches (opt-in banks); and all remaining organizations that are not mandatorily subject to and do not apply the advanced approaches (general banks).

For purposes of identifying core banks, the Agencies are proposing a set of objective criteria for industry consideration. Specifically, the Agencies are proposing to treat as a core bank any banking organization that has (1) total commercial bank (and thrift) assets of $250 billion or more, as reported on year-end regulatory reports (with banking assets of consolidated groups aggregated at the U.S. bank holding company level);[10] or (2) total on-balance-sheet foreign exposure of $10 billion or more, as reported on the year-end Country Exposure Report (FFIEC 009) (with foreign exposure of consolidated groups aggregated at the U.S. bank holding company level). These threshold criteria are independent; meeting either condition would mean an institution is a core bank.

Once an institution becomes a core bank it would remain subject to the advanced approaches on a going forward basis. If, in subsequent years, such an institution were to drop below both threshold levels it would continue to be a core bank unless it could demonstrate to its primary Federal supervisor that it has substantially and permanently downsized and should no longer be a core bank. The Agencies are proposing an annual test for assessing banking organizations in reference to the threshold levels. However, as a banking organization approaches either of the threshold levels the Agencies would expect to have ongoing dialogue with that organization to ensure that appropriate practices are in place or are actively being developed to prepare the organization for implementation of the advanced approaches.

Institutions that by expansion or merger meet the threshold levels must qualify for use of the advanced approaches and would be subject to the same implementation plan requirements and minimum risk-based capital floors applicable to core and opt-in banks as described below. Institutions that seek to become opt-in banks would be expected to notify their primary Federal supervisors well in advance of the date by which they expect to qualify for the advanced approaches. Based on the aforementioned threshold levels, the Agencies anticipate at this time that approximately ten U.S. institutions would be core banks.

Application of Advanced Approaches at Individual Bank/Thrift Levels

The Agencies are aware that some institutions might, on a consolidated basis, exceed one of the threshold levels for mandatory application of the A–IRB approach and AMA and, yet, might be comprised of distinct bank and thrift charters whose respective sizes fall well below the thresholds. In those cases, the Agencies believe that all bank and thrift institutions that are members of a consolidated group that is itself a core bank or an opt-in bank should calculate and report their risk-based capital requirements under the advanced approaches. However, recognizing that separate bank and thrift charters may, to a large extent, be independently managed and have different systems and portfolios, the Agencies are interested in comment on the efficacy and burden of a framework that requires the advanced approaches to be implemented by (or pushed down to) each of the separate subsidiary banks and thrifts that make up the consolidated group.

U.S. Banking Subsidiaries of Foreign Banking Organizations

Any U.S. bank or thrift that is a subsidiary of a foreign bank would have to comply with the prevailing U.S. regulatory capital requirements applied to U.S. banks. Thus, if a U.S. bank or

[9] In this regard, alternative approaches would take time to develop, but might present fewer implementation challenges. Additional work would be necessary to advance the goal of competitive equity among internationally active banking organizations. If consensus on alternative approaches could not be reached at the BSC, a departure from the Basel framework also could raise significant international and domestic issues.

[10] For banks this means the December Consolidated Report of Condition and Income (Call Report). For thrifts this means the December Thrift Financial Report.

thrift that is owned by a foreign bank meets the threshold levels for mandatory application of the advanced approaches, the U.S. bank or thrift would be a core bank. If it does not meet those thresholds, it would have the choice to opt-in to the advanced approaches (and be subject to the same supervisory framework as other U.S. banking organizations) or to remain a general bank. A top-tier U.S. bank holding company that is owned by a foreign bank also would be subject to the same threshold levels for core bank determination and would be subject to the applicable U.S. bank holding company capital rules. However, Federal Reserve SR Letter 01–1 (January 5, 2001) would remain in effect. Thus, subject to the conditions in SR Letter 01–1, a top-tier U.S. bank holding company that is owned or controlled by a foreign bank that is a qualifying financial holding company generally would not be required to comply with the Board's capital adequacy guidelines.

The Agencies are interested in comment on the extent to which alternative approaches to regulatory capital that are implemented across national boundaries might create burdensome implementation costs for the U.S. subsidiaries of foreign banks.

B. Implementation for Advanced Approach Organizations

As noted earlier, U.S. banking organizations that apply the advanced approaches would be required to comply with supervisory standards prior to use.

The BSC has targeted December 31, 2006 as the effective date for the international capital rules based on the New Accord. The Agencies are proposing an implementation date of January 1, 2007. The establishment of a final effective date in the United States, however, would be contingent on the issuance for public comment of a Notice of Proposed Rulemaking, and subsequent finalization of any changes in capital regulations that the Agencies ultimately decide to adopt.

Because of the need to pre-qualify for the advanced approaches, banking organizations would need to take a number of steps upon the finalization of any changes to the capital regulations. These steps would include developing detailed written implementation plans for the A–IRB approach and the AMA and keeping their primary supervisors advised of these implementation plans and schedules. Implementation plans would need to address all supervisory standards for the A–IRB approach and the AMA, include objectively measurable milestones, and demonstrate that adequate resources would be realistically budgeted and made available. An institution's board of directors would need to approve its implementation plans.

The Agencies expect core banks to make every effort to meet the supervisory standards as soon as practicable. In this regard, it is possible that some core banks would not qualify to use the advanced approaches in time to meet the effective date that is ultimately established. For those banking organizations, the implementation plan would need to identify when the supervisory standards would be met and when the institution would be ready for implementation. The Agencies note that developing an appropriate infrastructure to support the advanced approaches for regulatory capital that fully complies with supervisory conditions and expectations and the associated supervisory guidance will be challenging. The Agencies believe, however, that institutions would need to be fully prepared before moving to the advanced approaches.

Use of the advanced approaches would require the primary Federal supervisor's approval. Core banks unable to qualify for the advanced approaches in time to meet the effective date would remain subject to the general risk-based capital rules existing at that time. The Agencies would consider the effort and progress made to meet the qualifying standards and would consider whether, under the circumstances, supervisory action should be taken against or penalties imposed on individual core banks that have not adhered to the schedule outlined in the implementation plan they submitted to their primary Federal supervisor.

Opt-in banks meeting the supervisory standards could seek to qualify for the advanced approaches in time to meet the ultimate final effective date or any time thereafter. Institutions contemplating opting-in to the advanced approaches would need to provide notice to, and submit an implementation plan and schedule to be approved by, their primary Federal supervisor. As is true of core banks, opt-in banks would need to allow ample time for developing and executing implementation plans.

An institution's primary Federal supervisor would have responsibility for determining the institution's readiness for an advanced approach and would be ultimately responsible, after consultation with other relevant supervisors, for determining whether the institution satisfies the supervisory expectations for the advanced approaches. The Agencies recognize that a consistent and transparent process to oversee implementation of the advanced approaches would be crucial. The Agencies intend to develop interagency validation standards and procedures to help ensure consistency. The Agencies would consult with each other on significant issues raised during the validation process and ongoing implementation.

C. Other Considerations

General Banks

The Agencies expect that the vast majority of U.S. institutions would be neither core banks nor opt-in banks. Most institutions would remain subject to the general risk-based capital rules. However, as has been the case since the 1988 Accord was initially implemented in the United States, the Agencies will continue to make necessary modifications to the general risk-based capital rules as appropriate. In the event changes are warranted, the Agencies could implement revisions through notice and comment procedures prior to the proposed effective date of the advanced approaches in 2007.

The Agencies seek comment on whether changes should be made to the existing general risk-based capital rules to enhance their risk-sensitivity or to reflect changes in the business lines or activities of banking organizations without imposing undue regulatory burden or complication. In particular, the Agencies seek comment on whether any changes to the general risk-based capital rules are necessary or warranted to address any competitive equity concerns associated with the bifurcated framework.

Majority-Owned or Controlled Subsidiaries

The New Accord generally applies to internationally active banking organizations on a fully consolidated basis. Thus, consistent with the Agencies' general risk-based capital rules, subsidiaries that are consolidated under U.S. generally accepted accounting principles (GAAP) typically should be consolidated for regulatory capital calculation purposes under the advanced approaches as well.[11] With regard to investments in consolidated insurance underwriting subsidiaries, the New Accord notes that deconsolidation of assets and deduction of capital is an

[11] One notable exception exists at the bank level where there is an investment in a financial subsidiary as defined in the Gramm-Leach-Bliley Act of 1999. For such a subsidiary, assets would continue to be deconsolidated from the bank's on-balance-sheet assets, and capital at the subsidiary level would be deducted from the bank's capital.

appropriate approach. The Federal Reserve is actively considering several approaches to the capital treatment for investments by bank holding companies in insurance underwriting subsidiaries. For example, the Federal Reserve is currently assessing the merits and weaknesses of an approach that would consolidate an insurance underwriting subsidiary's assets at the holding company level and permit excess capital of the subsidiary to be included in the consolidated regulatory capital of the holding company. A deduction would be required for capital that is not readily available at the holding company level for general use throughout the organization.

The Federal Reserve specifically seeks comment on the appropriate regulatory capital treatment for investments by bank holding companies in insurance underwriting subsidiaries as well as other nonbank subsidiaries that are subject to minimum regulatory capital requirements.

Transitional Arrangements

Core and opt-in banks would be required to calculate their capital ratios using the A-IRB and AMA methodologies, as well as the general risk-based capital rules, for one year prior to using the advanced approaches on a stand-alone basis. In order to begin this parallel-run year, however, the institution would have to demonstrate to its supervisor that it meets the supervisory standards. Therefore, banking organizations planning to meet the January 1, 2007 target effective date for implementation of the advanced approaches would have to receive approval from their primary Federal supervisor before year-end 2005. Banking organizations that later adopt the advanced approaches also would have a one-year dual calculation period prior to moving to stand-alone usage of the advanced approaches.

An institution would be subject to a minimum risk-based capital floor for two years following moving to the advanced approaches on a stand-alone basis. Specifically, in the first year of stand-alone usage of the advanced approaches, an institution's calculated risk-weighted assets could not be less than 90 percent of risk-weighted assets calculated under the general risk-based capital rules. In the following year, an institution's minimum calculated risk-weighted assets could not be less than 80 percent of risk-weighted assets calculated under the general risk-based capital rules.[12]

As a consequence, advanced approach banking organizations would need to conduct two sets of capital calculations for at least three years. The pre-implementation calculation of A-IRB and AMA capital would not need to be made public, but the banking organization would be required to disclose risk-based capital ratios calculated under both advanced and general risk-based approaches during the two-year post-implementation period. The Agencies would not propose to eliminate the floors after the two-year transition period for any institution applying the advanced approaches until the Agencies are fully satisfied that the institution's systems are sound and accurately assess risk and that resulting capital levels are prudent.

These transitional arrangements and the floors established above relate only to risk-based capital ratios and do not affect the continued applicability to all advanced banking organizations of the leverage ratio and associated PCA regulations for banks and thrifts. Importantly, the minimum capital requirements and the PCA thresholds would not be changed. Furthermore, during the implementation period and before removal of the floors the Agencies intend to closely monitor the effect that the advanced approaches would have on capital levels at individual institutions and industry-wide capital levels. Once the results of this monitoring process are assessed, the Agencies may consider modifications to the advanced approaches to ensure that capital levels remain prudent.

Given the general principle that the advanced approaches are expected to be implemented at the same time across all material portfolios, business lines, and geographic regions, to what degree should the Agencies be concerned that, for example, data may not be available for key portfolios, business lines, or regions? Is there a need for further transitional arrangements? Please be specific, including suggested durations for such transitions.

Do the projected dates provide an adequate timeframe for core banks to be ready to implement the advanced approaches? What other options should the Agencies consider?

The Agencies seek comment on appropriate thresholds for determining whether a portfolio, business line, or geographic exposure would be material. Considerations should include relative asset size, percentages of capital, and associated levels of risk for a given portfolio, business line, or geographic region.

III. Advanced Internal Ratings-Based (A–IRB) Approach

This section describes the proposed A–IRB framework for the measurement of capital requirements for credit risk. Under this framework, banking organizations that meet the A–IRB infrastructure requirements and supervisory standards would incorporate internal estimates of risk inputs into supervisor-provided capital formulas for the various debt and equity portfolios to calculate the capital requirements for each portfolio. The discussion below provides background on the conceptual basis of the A–IRB approach and then describes the specific details of the capital formulas for two of the main exposure categories, wholesale and retail. Separate sections follow that describe the A–IRB treatments of loan loss reserves and partial charge-offs, the A–IRB treatment of purchased receivables, the A–IRB treatment of equity exposures, and the A–IRB treatment of securitization exposures. The A–IRB supervisory requirements and the A–IRB approach to credit risk mitigation techniques also are discussed in separate sections.

A. Conceptual Overview

The A–IRB framework has as its conceptual foundation the belief that any range of possible losses on a portfolio of credit exposures can be represented by a probability density function (PDF) of possible losses over a one-year time horizon. If known, the parameters of a PDF can be used to specify a particular level of capital that will lower the probability of the institution's insolvency due to adverse credit risk outcomes to a stated confidence level. With a known or estimated PDF, the probability of insolvency can be measured or estimated directly, based on the level of reserves and capital available to an institution.

The A–IRB framework builds off this concept and reflects an effort to develop a common set of risk-sensitive formulas for the calculation of required capital for credit risk. To a large extent, this framework resembles more systematic quantitative approaches to the

[12] The agencies note that the text above differs from the floor text in the New Accord, which is based on 90 and 80 percent of the minimum capital requirements under the 1988 Accord, rather than on risk-weighted assets. The Agencies expect that the final language of the New Accord would need to be consistent with this approach. The following example reflects how the floor in the first year would be applied by a U.S. banking organizaiton. If the banking organization's general risk-based capital calculation produced risk-weighted assets of $100 billion in its first year of implementation of the advanced approaches, then its risk weighted assets in that year could not be less than $90 billion. If the advanced approach calculation produced risk-weighted assets of $75 billion (a decrease of one quarter compared to the general risk-based capital rules), the organization would not calculate risk-based capital ratios on the basis of that $75 billion; rather, its risk-weighted assets would be $90 billion. Consequently, its minimum total risk-based capital charge would be $7.2 billion, and it would need $9 billion to satisfy PCA well-capitalized criteria.

measurement of credit risk that many banking organizations have been developing. These approaches being developed by banking organizations generally rely on a statistical or probability-based assessment of credit risk and use inputs broadly similar to those required under the A–IRB approach. Like the value-at-risk (VaR) model that forms the basis for the market risk capital rules, the output of these statistical approaches to credit risk is typically an estimate of loss threshold on a credit exposure or pool of credit exposures that is highly unlikely to be exceeded by actual credit-related losses on the exposure or pool.

Many banking organizations now use such a credit VaR amount as the basis for an internal assessment of the economic capital necessary to cover credit risk. In this context, it is common for banking organizations' internal credit risk models to consider a one-year loss horizon, and to focus on a high loss threshold confidence level (that is, a loss threshold that has a small probability of being exceeded), such as the 99.95th percentile. This is because banking organizations typically seek to hold an amount of economic capital for credit risk whose probability of being exceeded is broadly consistent with the institution's external credit rating and its associated default probability. For example, the one-year historical probability of default for AA-rated firms is less than 5 basis points (0.05 percent).

There is a great deal of variation across banking organizations in the specifics of their credit risk measurement approaches. It is important to recognize that the A–IRB approach is not intended to allow banking organizations to use all aspects of their own models to estimate regulatory capital for credit risk. The A–IRB approach has been developed as a single, common methodology that all advanced approach banking organizations would use, and consists of a set of formulas (or functions) and a single set of assumptions regarding critical parameters for the formulas. The A–IRB approach draws on the same conceptual underpinnings as the credit VaR approaches that banking organizations have developed individually, but likely differs in many specifics from the approach used by any individual institution.

The specific A–IRB formulas require the banking organization first to estimate certain risk inputs, which the organization may do using a variety of techniques. The formulas themselves, into which the estimated risk inputs are inserted, are broadly consistent with the most common statistical approaches for measuring credit risk, but also are more straightforward to calculate than those typically employed by banking organizations (which often require computer simulations). In particular, an important property of the A–IRB formulas is portfolio invariance. That is, the A–IRB capital requirement for a particular exposure generally does not depend on the other exposures held by the banking organization; as with the general risk-based capital rules, the total credit risk capital requirement for a banking organization is simply the sum of the credit risk capital requirements on individual exposures or pools of exposures.[13]

As with the existing credit VaR models, the output of the A–IRB formulas is an estimate of the amount of credit losses over a one-year period that would only be exceeded a small percentage of the time. In the case of the A–IRB formulas, this nominal confidence level is set to 99.9 percent. This means that within the context of the A–IRB modeling assumptions a banking organization's overall credit portfolio capital requirement can be thought of as an estimate of the 99.9th percentile of potential losses on that portfolio over a one-year period. In practice, however, this 99.9 percent nominal target likely overstates the actual level of confidence because the A–IRB framework does not explicitly address portfolio concentration issues or the possibility of errors in estimating PDs, LGDs, or EADs. The choice of the 99.9th percentile reflects a desire on the part of the Agencies to align the regulatory capital standard with the default probabilities typically associated with maintaining low investment grade ratings (that is, BBB) even in periods of economic adversity and to ensure neither a substantial increase or decrease in overall required capital levels among A–IRB banking organizations compared with the capital levels that would be required under the general risk-based capital rules. It also recognizes that the risk-based capital rules count a broader range of instruments as eligible capital (for example, certain subordinated debt) than do internal economic capital methodologies.

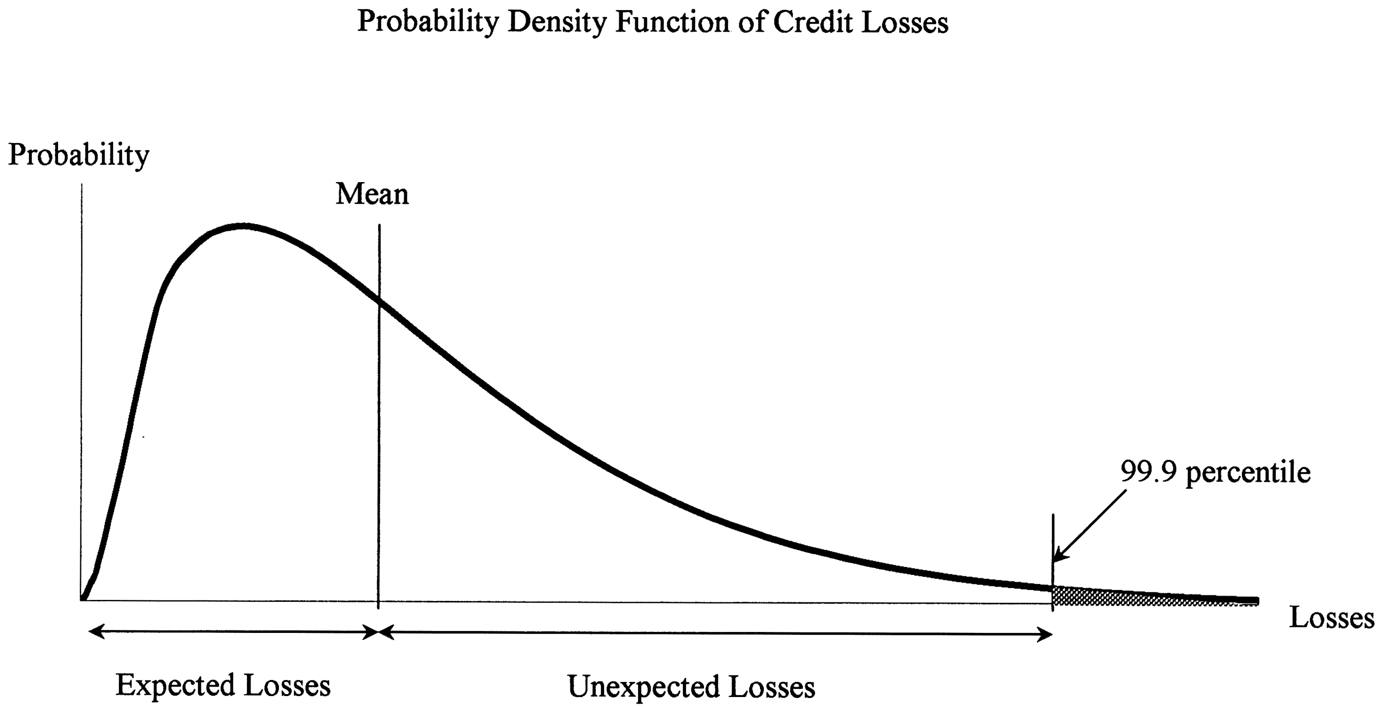
Expected Losses Versus Unexpected Losses

The diagram below shows a hypothetical loss distribution for a portfolio of credit exposures over a one-year horizon. The loss distribution is represented by the curve, and is drawn in such a way that it depicts a higher proportion of losses falling below the mean value than falling above the mean. The average value of credit losses is referred to as expected loss (EL). The losses that exceed the expected level are labeled unexpected loss (UL). An overarching policy question concerns whether the proposed design of the A–IRB capital requirements should reflect an expectation that institutions would allocate capital to cover both EL and a substantial portion of the range of possible UL outcomes, or only the UL portion of the range of possible losses (that is, from the EL point out to the 99.9th percentile).

The Agencies recognize that some institutions, in their comment letters on earlier BSC proposals and in discussion with supervisory staffs, have highlighted the view that regulatory capital should not be allocated for EL. They emphasize that EL is normally incorporated into the interest rate and spreads charged on specific products, such that EL is covered by net interest margin and provisioning. The implication is that supervisors would review provisioning policies and the adequacy of reserves as part of a supervisory review, much as they do today, and would require additional reserves and/or regulatory capital for EL in cases where reserves were deemed insufficient. However, the Agencies are concerned that the accounting definition of general reserves differs significantly across countries, and that banking practices with respect to the recognition of impairment also are very different. Thus, the Agencies are proposing to include EL in the calibration of the risk weight functions.

The Agencies also note that the current regulatory definition of capital includes a portion of general reserves. That is, general reserves up to 1.25 percent of risk-weighted assets are included in the Tier 2 portion of total capital. If the risk weight functions were calibrated solely to UL, it could be argued that the definition of capital would also need to be revisited. In the United States, such a discussion would require a review of the provisioning practices of institutions under GAAP and of the distinctions drawn between specific and general provisions.

[13] The theoretical underpinnings for obtaining portfolio-invariant capital charges within credit VaR models are provided in the paper ''A Risk-Factor Model Foundation for Ratings-Based Bank Capital Rules,'' by Michael Gordy, forthcoming in the *Journal of Financial Intermediation.* The A–IRB formulas are derived as an application of these results to a single-factor CreditMetrics-style mode. For mathematical details of this model, see M. Gordy, ''A comparative Anatomy of Credit Risk Models.'' *Journal of Banking and Finance,* January 2000, or H.R. Koyluogu and A. Hickman, ''Reconcilable Differences.'' *Risk,* October 1998.



The framework described in this ANPR calibrates the risk-based capital requirements to the sum of EL plus UL, which raises significant calibration issues. Those calibration issues would be treated differently if the calibration were based only on the estimate of UL. That is, decisions with respect to significant policy variables that are described below hinge crucially on the initial decision to base the calibration on EL plus UL, rather than UL only. These issues include, for example, the appropriate mechanism for incorporating any future margin income (FMI) that is associated with particular business lines, as well as the appropriate method for incorporating general and specific reserves into the risk-based capital ratios.

A final overarching assumption of the A–IRB framework is the role of asset correlations. Within the A–IRB capital formulas (as in the credit VaR models of many banking organizations), asset correlation parameters provide a measure of the extent to which changes in the economic value of separate exposures are presumed to move together. A higher asset correlation between a particular asset and other assets in the same portfolio implies a greater likelihood that the asset will decline in value at the same time as the portfolio as a whole declines in value. Because this means a greater chance that the asset will be a contributor to high loss scenarios, its capital requirement under the A–IRB framework also is higher.

Specifically, the A–IRB capital formulas described in detail below are based on the assumption that correlation in defaults across borrowers is attributable to their common dependence on one or more systematic risk factors. The basis for this assumption is the observation that a banking organization's borrowers are generally susceptible to adverse changes in the global economy. These systematic factors are distinct from the borrower-specific, or idiosyncratic, risk factors that determine the probability that a specific loan will be repaid. Like other risk-factor models, the A–IRB framework assumes that these borrower-specific factors represent idiosyncratic sources of risk, and thus (unlike the systematic risk-factors) are diversified in a large lending portfolio.

The A–IRB approach allows for much improved sensitivity to many of the loan-level determinants of economic capital (such as PD and LGD), but does not explicitly address how an exposure's economic capital might vary with the degree of concentration in the overall portfolio to specific industries or regions, or even to specific borrowers. That is, it neither rewards nor penalizes differences across banking organizations in diversification or concentration across industry, geography, and names. To introduce such rewards and penalties in an appropriate manner would necessarily entail far greater operational complexity for both regulatory and financial institutions.

In contrast, the portfolio models of credit risk employed by many banking organizations are quite sensitive to all forms of diversification. That is, the economic capital charge assigned to a loan within such a model will depend on the portfolio as a whole. In order to apply a portfolio model to the calibration of A–IRB capital charges, it would be necessary to identify the assumptions needed so that a portfolio model would yield economic capital charges that do not depend on portfolio characteristics. Recent advances in the finance literature demonstrate that economic capital charges are portfolio-invariant if (and only if) two assumptions are imposed.[14] First, the portfolio must be infinitely fine-grained. Second, there must be only a single systematic risk factor.

Infinite granularity, while never literally attained, is satisfied in an approximate sense by the portfolios of large, internationally active banks. Analysis of data provided by such institutions shows that taking account of single-name concentrations in such portfolios would lead to only trivial changes in the total capital requirement. The single risk-factor assumption would appear, at first glance, more troublesome. As an empirical matter, there undoubtedly are distinct cyclical factors for different industries and different geographic regions. From a substantive perspective, however, the

[14] See forthcoming paper by M. Gordy referenced in footnot number 12 above.

relevant question is whether portfolios at large financial institutions are diversified across the various sub-sectors of the economy in a reasonably similar manner. If so, then the portfolio can be modeled as if there were only a single factor, namely, the credit cycle as a whole.

The Agencies seek comment on the conceptual basis of the A–IRB approach, including all of the aspects just described. What are the advantages and disadvantages of the A–IRB approach relative to alternatives, including those that would allow greater flexibility to use internal models and those that would be more cautious in incorporating statistical techniques (such as greater use of credit ratings by external rating agencies)? The Agencies also encourage comment on the extent to which the necessary conditions of the conceptual justification for the A–IRB approach are reasonably met, and if not, what adjustments or alternative approach would be warranted.

Should the A–IRB capital regime be based on a framework that allocates capital to EL plus UL, or to UL only? Which approach would more closely align the regulatory framework to the internal capital allocation techniques currently used by large institutions? If the framework were recalibrated solely to UL, modifications to the rest of the A–IRB framework would be required. The Agencies seek commenters' views on issues that would arise as a result of such recalibration.

B. A–IRB Capital Calculations

A common characteristic of the A–IRB capital formulas is that they calculate the actual dollar value of the minimum capital requirement associated with an exposure (or, in the case of retail exposures, a pool of exposures). This capital requirement must be converted to an equivalent amount of risk-weighted assets in order to be inserted into the denominator of a banking organization's risk-based capital ratios. Because the minimum risk-based capital ratio in the United States is 8 percent, the minimum capital requirement on any asset would be equal to 8 percent of the risk-weighted asset amount associated with that asset. Therefore, in order to determine the amount of risk-weighted assets to associate with a given minimum capital requirement, it would be necessary to multiply the dollar capital requirement generated by the A–IRB formulas by the reciprocal of 8 percent, or 12.5.

The following subsections of the ANPR detail the specific features of the A–IRB capital formulas for two principal categories of credit exposure: wholesale and retail. Both of these subsections include a proposed definition of the exposure category, a description of the banking organization-estimated inputs required to complete the capital calculations, a description of the specific calculations required to determine the A–IRB capital requirement, and tables depicting a range of representative results.

Wholesale Exposures: Definitions and Inputs

The Agencies propose that a single credit exposure category—wholesale exposures—would encompass most non-retail credit exposures in the A–IRB framework. The wholesale category would include the sub-categories of corporate, sovereign, and interbank exposures as well as all types of specialized lending exposures. Wholesale exposures would include debt obligations of corporations, partnerships, limited liability companies, proprietorships, and special-purpose entities (including those created specifically to finance and/or operate physical assets). Wholesale exposures also would include debt obligations of banks and securities firms (interbank exposures), and debt obligations of central governments, central banks, and certain public-sector entities (sovereign exposures). The wholesale exposure category would not include securitization exposures, or certain small-business exposures that are eligible to be treated as retail exposures.

The Agencies propose that advanced approach banking organizations would use the same A–IRB capital formula to compute capital requirements on all wholesale exposures with two exceptions. First, wholesale exposures to small- and medium-sized enterprises (SMEs) would use a downward adjustment to the wholesale A–IRB capital formula typically based on borrower size. Second, the A–IRB capital formula for HVCRE loans (generally encompassing certain speculative ADC loans) would use a higher asset correlation assumption than other wholesale exposures.

The proposed A–IRB capital framework for wholesale exposures would require banking organizations to assign four key risk inputs for each individual wholesale exposure: (1) Probability of default (PD); (2) loss given default (LGD); (3) exposure at default (EAD); and (4) effective remaining maturity (M). In addition, to use the proposed downward adjustment for wholesale SMEs described in more detail below, banking organizations would be required to provide an additional input for borrower size (S).

Probability of Default

The first principal input to the wholesale A–IRB calculation is the measure of PD. Under the A–IRB approach, a banking organization would assign an internal rating to each of its wholesale obligors (or in other words, assign each wholesale exposure to an internal rating grade applicable to the obligor). The internal rating would have to be produced by a rating system that meets the A–IRB infrastructure requirements and supervisory standards for wholesale exposures, which are intended to ensure (among other things) that the rating system results in a meaningful differentiation of risk among exposures. For each internal rating, the banking organization must associate a specific one-year PD value. Various approaches may be used to develop estimates of PDs; however, regardless of the specific approach, banking organizations would be expected to satisfy the supervisory standards. The minimum PD that may be assigned to most wholesale exposures is 3 basis points (0.03 percent). Certain wholesale exposures are exempt from this floor, including exposures to sovereign governments, their central banks, the BIS, IMF, European Central Bank, and high quality multilateral development banks (MDBs) with strong shareholder support.

The Agencies intend to apply standards to the PD quantification process that are consistent with the broad guidance outlined in the New Accord. More detailed discussion of those points is provided in the draft supervisory guidance on IRB approaches for corporate exposures published elsewhere in today's **Federal Register**.

Loss Given Default

The second principal input to the A–IRB capital formula for wholesale exposures is LGD. Under the A–IRB approach, banking organizations would estimate an LGD for each wholesale exposure. An LGD estimate for a wholesale exposure should provide an assessment of the expected loss in the event of default of the obligor, expressed as a percentage of the institution's estimated total exposure at default. The LGD for a defaulted exposure would be estimated as the expected economic loss rate on that exposure taking into account, where appropriate, recoveries, workout costs, and the time value of money. Banking organizations would estimate LGDs as the loss severities expected to prevail when default rates are high, unless they have information indicating that recoveries on a particular class of exposure are unlikely to be affected to an appreciable extent by cyclical factors. As with estimates of other A–IRB inputs, banking organizations would be expected to be conservative in assigning LGDs.

Although estimated LGDs should be grounded in historical recovery rates, the A–IRB approach is structured to allow banking organizations to assess the differential impact of various factors, including, for example, the presence of collateral or differences in loan terms and covenants. The Agencies expect to impose limitations on the use of guarantees and credit derivatives in a banking organization's LGD estimates. These limitations are discussed in the separate section of this ANPR on the A–IRB treatment of credit risk mitigation techniques.

Exposure at Default

The third principal input to the wholesale A–IRB capital formula is EAD. The Agencies are proposing that banking organizations would provide their own estimate of EAD for each exposure. The EAD for an exposure would be defined as the amount legally owed to the banking organization (net of any charge-offs) in the event that the borrower defaults on the exposure. For on-balance-sheet items, banking organizations would estimate EAD as no less than the current drawn amount. For off-balance-sheet items, except over-the-counter (OTC) derivative transactions, banking organizations would assign an EAD equal to an estimate of the long-run default-weighted average EAD for similar facilities and borrowers or, if EADs are highly cyclical, the EAD expected to prevail when default rates are high. The EAD associated with OTC derivative transactions would continue to be estimated using the ''add-on'' approach contained in the general risk-based capital rules.[15] In addition, there would be a specific EAD calculation for the recognition of collateral in the context of repo-style transactions subject to a master netting agreement, the features of which are outlined below in the section on the A–IRB treatment of credit risk mitigation techniques.[16]

[15] Under the add-on approach, an institution would determine its EAD for an OTC derivative contract by adding the current value of the contract (zero if the current value is negative) and an estimate of potential future exposure (PFE) on the contract. The estimated PFE would be equal to the notional amount of the derivative multiplied by a supervisor-provided add-on factor that takes into account the type of instrument and its maturity.

[16] Repo-style transactions include reverse repurchase agreements and repurchase agreements and securities lending and borrowing.

Definition of Default and Loss

A banking organization would estimate inputs relative to the following definition of default and loss. A default is considered to have occurred with respect to a particular borrower when either or both of the following two events has taken place: (1) The banking organization determines that the borrower is unlikely to pay its obligations to the organization in full, without recourse to actions by the organization such as the realization of collateral; or (2) the borrower is more than 90 days past due on principal or interest on *any* material obligation to the organization. The Agencies believe that the use of the concept of ''unlikely to pay'' is largely consistent with the practice of U.S. banking organizations in assessing whether a loan is on non-accrual status.

Maturity

The fourth principal input to the A–IRB capital formula is effective remaining maturity (M), measured in years. If a wholesale exposure is subject to a determinable cash flow schedule, the banking organization would calculate M as the weighted-average remaining maturity of the expected cash flows, using the amounts of the cash flows as the relevant weights. The banking organization also would be able to use the nominal remaining maturity of the exposure if the weighted-average remaining maturity of the exposure cannot be calculated. For OTC derivatives and repo-style transactions subject to master netting agreements, the institution would set M equal to the weighted-average remaining maturity of the individual transactions, using the notional amounts of the individual transactions as the relevant weights.

In all cases, M would be set no greater than five years and, with few exceptions, M would be set no lower than one year. The exceptions apply to certain transactions that are not part of a banking organization's ongoing financing of a borrower. For wholesale exposures that have an original maturity of less than three months—including repo-style transactions, money market transactions, trade finance-related transactions, and exposures arising from payment and settlement processes—M may be set as low as one day. For OTC derivatives and repo-style transactions subject to a master netting agreement, M would be set at no less than five days.

As with the assignment of PD estimates, the Agencies propose to apply supervisory standards for the estimation of LGD, EAD, and M that are consistent with the broad guidance contained in the New Accord. More detailed discussion of these issues is provided in the draft supervisory guidance on IRB approaches for corporate exposures published elsewhere in today's **Federal Register.**

The Agencies seek comment on the proposed definition of wholesale exposures and on the proposed inputs to the wholesale A–IRB capital formulas. What are views on the proposed definitions of default, PD, LGD, EAD, and M? Are there specific issues with the standards for the quantification of PD, LGD, EAD, or M on which the Agencies should focus?

Wholesale Exposures: Formulas

The calculation of the A–IRB capital requirement for a particular wholesale exposure would be accomplished in three steps:

(1) Calculation of the relevant asset correlation parameter, which would be a function of PD (as well as borrower size (S) for SMEs);

(2) Calculation of a preliminary capital requirement assuming a maturity of one year, which would be a function of PD, LGD, EAD, and the asset correlation parameter calculated in the first step; and

(3) Application of a maturity adjustment for differences between the actual effective remaining maturity of the exposure and the one-year maturity assumption in the second step, where the adjustment would be a function of both PD and M.

These calculations result in the A–IRB capital requirement, expressed in dollars, for a particular wholesale exposure. As noted earlier, this amount would be converted to a risk-weighted assets equivalent by multiplying the amount by 12.5, and the risk-weighted assets equivalent would be included in the denominator of the risk-based capital ratios.

Asset Correlation

The first step in the calculation of the A–IRB capital requirement for a wholesale exposure is the calculation of the asset correlation parameter, which is denoted by the letter ''R'' in the formulas below. This asset correlation parameter is not a fixed amount; rather, the parameter varies as an inverse function of PD. For all wholesale exposures except HVCRE exposures, the asset correlation parameter approaches an upper bound value of 24 percent for very low PD values and approaches a lower bound value of 12 percent for very high PD values. This reflects the Agencies' view that borrowers with lower credit quality (that is, higher PDs) are likely to be more idiosyncratic in the factors affecting their likelihood of default than borrowers with higher credit quality (lower PDs). Therefore, the higher PD borrowers are proportionately less influenced by systematic (sector-wide or economy-wide) factors common to all borrowers.[17]

An important practical impact of having asset correlation decline with increases in PD

[17] See Jose Lopez, ''The Empirical Relationship between Average Asset Correlation, Firm Probability of Default, and Asset Size.'' Federal Reserve Bank of San Francisco Working Paper 02–05 (June 2002).

is to reduce the speed with which capital requirements increase as PDs increase, and to increase the speed with which EL dominates the total capital charge, thereby tending to reduce procyclicality in the application of the wholesale A–IRB capital formulas. The specific formula for determining the asset correlation parameter for all wholesale exposures except HVCRE exposures is as follows:

$$R = 0.12 * (1 - EXP(-50 * PD)) + 0.24 * [1 - (1 - EXP(-50 * PD))]$$

Where:

R denotes asset correlation;
EXP(x) denotes the natural exponential function; and
PD denotes probability of default.

Capital Requirement With Assumed One-Year Maturity Adjustment

The second step in the calculation of the A–IRB capital requirement for a particular wholesale exposure is the calculation of the capital requirement that would apply to the exposure assuming a one-year effective remaining maturity. The specific formula to calculate this one-year-maturity capital requirement is as follows:

$$K_1 = EAD * LGD * N[(1 - R)\wedge - 0.5 * G(PD) + (R/(1 - R))\wedge 0.5 * G(0.999)]$$

Where:

K_1 denotes the one-year-maturity capital requirement;
EAD denotes exposure at default;
LGD denotes loss given default;
N(x) denotes the standard normal cumulative distribution function;
R denotes asset correlation;
G(x) denotes the inverse of the standard normal cumulative distribution function; and [18]
PD denotes probability of default.

There are several important aspects of this formula. First, it rises in a straight-line fashion with increases in EAD, meaning that a doubling of the exposure amount would result in a doubling of the capital requirement. It also rises in a straight-line fashion with increases in LGD, which similarly implies that a loan with an LGD estimate twice that of an otherwise identical loan would have twice the capital requirement of the other loan. This also implies that as LGD or EAD estimates approach zero, the capital requirement would likewise approach zero. The remainder of the formula is a function of PD, asset correlation (R), which is itself a function of PD, and the target loss percentile amount of 99.9 percent discussed earlier.

Maturity Adjustment

The third stage in the calculation of the A–IRB capital requirement for a particular wholesale exposure is the application of a maturity adjustment to reflect the exposure's actual effective remaining maturity (M). The A–IRB maturity adjustment multiplies the one-year-maturity capital requirement (K_1) by a factor that depends on both M and PD. The fact that the A–IRB maturity adjustment depends on PD reflects the Agencies' view that there is a greater proportional need for maturity adjustments for high-quality exposures (those with low PDs) because there is a greater potential for such exposures to deteriorate in credit quality than for exposures whose credit quality is lower. The specific formula for applying the maturity adjustment and generating the A–IRB capital requirement is as follows:

$$K = K_1 * [1 + (M - 2.5) * b]/[(1 - 1.5 * b)], \text{ where } b = (0.08451 - 0.05898 * LN(PD))^2$$

and:

K denotes the A–IRB capital requirement;
K_1 denotes the one-year-maturity capital requirement;
M denotes effective remaining maturity;
LN(x) denotes the natural logarithm; and
PD denotes probability of default.

In this formula, the value ''b'' effectively determines the slope of the maturity adjustment and is itself a function of PD. Note that if M is set equal to one, the maturity adjustment also equals one and K will therefore equal K_1.

To provide a more concrete sense of the range of capital requirements under the wholesale A–IRB framework, the following table presents the A–IRB capital requirements (K) for a range of values of both PD and M. In this table LGD is assumed to equal 45 percent. For comparison purposes, the general risk-based capital rules assign a capital requirement of 8 percent for most commercial loans.

CAPITAL REQUIREMENTS

[In percentage points]

PD	Effective remaining maturity (M)			
	1 month	1 year	3 years	5 years
0.05 percent	0.50	0.92	1.83	2.74
0.10 percent	1.00	1.54	2.71	3.88
0.25 percent	2.17	2.89	4.44	5.99
0.50 percent	3.57	4.40	6.21	8.03
1.00 percent	5.41	6.31	8.29	10.27
2.00 percent	7.65	8.56	10.56	12.56
5.00 percent	11.91	12.80	14.75	16.69
10.00 percent	17.67	18.56	20.50	22.45
20.00 percent	26.01	26.84	28.65	30.47

The impact of the A–IRB capital formulas on minimum risk-based capital requirements for wholesale exposures would, of course, depend on the actual values of PD, LGD, EAD, and M that banking organizations would use as inputs to the wholesale formulas. Subject to the caveats noted earlier, evidence from QIS3 suggested an average reduction in credit risk capital requirements for corporate exposures of about 26 percent for twenty large U.S. banking organizations.

SME Adjustment

For loans to SMEs not eligible for retail A–IRB treatment, the proposed calculation of the A–IRB capital requirement has one additional element—a downward adjustment based on borrower size (S). This adjustment would effectively lower the A–IRB capital requirement on wholesale exposures to SMEs with annual sales (or total assets) of less than $50 million. The Agencies believe the measure of borrower size should be based on annual sales (rather than total assets), unless the banking organization can demonstrate that it would be more appropriate for the banking organization to use the total assets of the borrower as its measure of borrower size. The borrower size adjustment would be made to the asset correlation parameter (R), as shown in the following formula:

$$R_{SME} = R - 0.04 * [1 - (S - 5)/45]$$

Where

R_{SME} denotes the size-adjusted asset correlation;
R denotes asset correlation; and

[18] The N(x) and G(x) functions are widely used in statistics and are commonly available in computer spreadsheet programs. A description of these functions may be found in the Help function of most spreadsheet programs or in basic statistical textbooks.

S denotes borrower size (expressed in millions of dollars).

The maximum reduction in the asset correlation parameter based on this formula is 4 percent, and is achieved when borrower size is $5 million. For all borrower sizes below $5 million, borrower size would be set equal to $5 million. The adjustment shrinks to zero as borrower size approaches $50 million. The broad rationale for this adjustment is the view that the credit condition of SMEs will be influenced relatively more by idiosyncratic factors than is the case for larger firms, and, thus, SMEs would be less likely to deteriorate simultaneously with other exposures. This greater susceptibility to idiosyncratic factors would imply lower asset correlation. The evidence in favor of this view is mixed, particularly after considering that the A–IRB framework already incorporates a negative relationship between asset correlation and PD. The following table illustrates the practical effect of the SME adjustment by depicting the capital requirements (K) across a range of PDs and borrower sizes. As in the previous table, LGD is assumed to equal 45 percent. For this table, M is assumed to be equal to three years. Note that the last column is identical to the three-year maturity column in the preceding table because the SME adjustment is phased out for borrowers of $50 million or more in size.

CAPITAL REQUIREMENTS

[In percentage points]

PD	Borrower size (S)			
	$5 million	$20 million	$35 million	≥ $50 million
0.05 percent	1.44	1.57	1.70	1.83
0.10 percent	2.14	2.33	2.51	2.71
0.25 percent	3.54	3.83	4.13	4.44
0.50 percent	4.97	5.37	5.79	6.21
1.00 percent	6.63	7.17	7.72	8.29
2.00 percent	8.40	9.11	9.83	10.56
5.00 percent	11.70	12.73	13.74	14.75
10.00 percent	16.76	18.05	19.30	20.50
20.00 percent	24.67	26.08	27.40	28.65

Subject to the caveats mentioned above, evidence from QIS3 suggested an average reduction in credit risk-based capital requirements for corporate SME exposures of about 39 percent for twenty large U.S. banking organizations.

If the Agencies include a SME adjustment, are the $50 million threshold and the proposed approach to measurement of borrower size appropriate? What standards should be applied to the borrower size measurement (for example, frequency of measurement, use of size buckets rather than precise measurements)?

Does the proposed borrower size adjustment add a meaningful element of risk sensitivity sufficient to balance the costs associated with its computation? The Agencies are interested in comments on whether it is necessary to include an SME adjustment in the A–IRB approach. Data supporting views is encouraged.

Wholesale Exposures: Other Considerations

Specialized Lending

The specialized lending (SL) asset class encompasses exposures for which the primary source of repayment is the income generated by the specific asset(s) being financed, rather than the financial capacity of a broader commercial enterprise. The SL category encompasses four broad exposure types:

- *Project finance* (PF) exposures finance large, complex, expensive installations that produce goods or services for sale, such as power plants, chemical processing plants, mines, or transportation infrastructure, where the source of repayment is primarily the revenues generated by sale of the goods or services by the installations.
- *Object finance* (OF) exposures finance the acquisition of (typically moveable) physical assets, such as ships or aircraft, where the source of repayment is primarily the revenues generated by the assets being financed, often through rental or lease contracts with third parties.
- *Commodities finance* (CF) exposures are structured short-term financings of reserves, inventories, or receivables of exchange-traded commodities, such as crude oil, metals, or agricultural commodities, where the source of repayment is the proceeds of the sale of the commodity.
- *Commercial real estate* (CRE) exposures finance the construction or acquisition of real estate (including land as well as improvements) where the prospects for repayment and recovery depend primarily on the cash flows generated by the lease, rental, or sale of the real estate.[19] The broad CRE category is further divided into two groups: low-asset-correlation CRE and HVCRE.[20]

Most of the issues raised below for comment are described in substantially greater detail, in the context of CRE exposures, in a white paper entitled ''Loss Characteristics of CRE Loan Portfolios,'' released by the Federal Reserve Board on June 10, 2003. Commenters are encouraged to read the white paper in conjunction with this section.

A defining characteristic of SL exposures (including CRE) is that the risk factors influencing actual default rates are likely to influence LGDs as well. This is because both the borrower's ability to repay an exposure *and* the banking organization's recovery on an exposure in the event of default are likely to depend on the same underlying factors, such as the net cash flows of the property being financed.

[19] CRE exposures are typically non-recourse exposures, often to special purpose vehicles, and are distinguishable from corporate exposures that are collateralized by real estate for which the prospects for repayment and recovery depend primarily on the financial performance of the broader commercial enterprise that is the obligor.

[20] To describe a loan portfolio as having a relatively high asset correlation means that any defaults that occur in that portfolio are relatively likely to occur at the same time, and for this reason the portfolio is likely to exhibit greater variability in aggregate default rates. For two portfolios with the same EL, the portfolio with more highly variable aggregate default rates warrants higher capital to cover UL (''bad-tail events'') with the same level of confidence. Describing a portfolio as having a relatively high asset correlation does *not* imply that loans in that portfolio have relatively high PD, LGD, or EL. In particular, loans in high asset correlation portfolios may well have very low PDs and LGDs and therefore ELs); conversely, loans in low asset correlation portfolios may have very high PDs and LGDs (and ELs). For any two loans from a portfolio with a given asset correlation (or from two different portfolios with the same asset correlation), the loan with the lower EL should be assigned a lower risk weight. For any two loans with the same EL, the loan from the portfolio with the lower asset correlation should incur a lower capital charge, because bad-tail events are less likely to occur in that portfolio.

This suggests a positive correlation between observed default frequencies and observed loss rates on defaulted loans, with both declining during periods of favorable economic conditions and both increasing during unfavorable economic periods. While cyclicality in LGDs may be significant for a number of lending activities, the Agencies believe that cyclicality is likely to be the norm for SL portfolios, and that a banking organization's procedures for estimating LGD inputs for SL exposures should assess and quantify this cyclicality in a comprehensive and systematic fashion.

The Agencies invite comment on ways to deal with cyclicality in LGDs. How can risk sensitivity be achieved without creating undue burden?

For core and opt-in banks that may not be able to provide sufficiently reliable estimates of PD, LGD, and M for each SL exposure, the New Accord offers a Supervisory Slotting Criteria (SSC) approach. Under this approach, rather than estimating the loan-level risk parameters, banking organizations would use slotting criteria to map their internal risk rating grades to one of five supervisory rating grades: Strong, Good, Satisfactory, Weak, and Default. In addition, supervisory risk weights would be assigned to each of these supervisory rating grades. To assist banking organizations in implementing these supervisory rating grades, for reference purposes the New Accord associates each with an explicit range of external rating grades. If the SSC approach were allowed in the United States, the Agencies would have to develop slotting criteria that would take into account factors such as market conditions; financial ratios such as debt service coverage or loan-to-value ratios; cash flow predictability; strength of sponsor or developer; and other factors likely to affect the PD and/or LGD of each loan.

The Agencies invite comment on the merits of the SSC approach in the United States. The Agencies also invite comment on the specific slotting criteria and associated risk weights that should be used by organizations to map their internal rating grades to supervisory rating grades if the SSC approach were to be adopted in the United States.

Under the A–IRB approach, a banking organization would estimate the risk inputs for each SL exposure and then calculate the A–IRB capital charge for the exposure by substituting the estimated PD, LGD, EAD, and M into one of two risk weight functions. The first risk weight function is the wholesale risk weight function and applies to all PF, OF, and CF exposures, as well as to all low-asset-correlation CRE exposures (including in-place commercial properties). The second risk weight function applies to all HVCRE exposures. It also is the same as the wholesale risk weight function, except that it incorporates a higher asset correlation parameter. The asset correlation equation for HVCRE is as follows:

$$R = 0.12 \times (1 - EXP(-50 \times PD)) + 0.30 \times [EXP(-50 \times PD)]$$

Where

R denotes asset correlation;

EXP denotes the natural exponential function; and

PD denotes probability of default.

The following table presents the A–IRB capital requirement (K) for a range of values of both PD and M. In this table, LGD is assumed to equal 45 percent. This LGD is used for consistency with the similar table above for wholesale exposures and should not be construed as an indication that 45 percent is a typical LGD for HVCRE exposures.

HVCRE CAPITAL REQUIREMENTS

[In percentage points]

PD	Effective remaining maturity		
	1 year	3 years	5 years
0.05 percent	1.24	2.46	3.68
0.10 percent	2.05	3.61	5.16
0.25 percent	3.74	5.76	7.77
0.50 percent	5.52	7.79	10.07
1.00 percent	7.53	9.89	12.25
2.00 percent	9.55	11.79	14.02
5.00 percent	13.12	15.12	17.11
10.00 percent	18.59	20.54	22.49
20.00 percent	26.84	28.65	30.47

All ADC loans would be treated as HVCRE exposures, unless the borrower has ''substantial equity'' at risk or the property is pre-sold or sufficiently pre-leased. In part, this reflects some empirical evidence suggesting that most ADC loans have relatively high asset correlations. It also, however, reflects a longstanding supervisory concern that CRE lending to finance speculative construction and development is vulnerable to, and may worsen, speculative swings in CRE markets, especially when there is little borrower equity at risk. Such lending was a major factor causing the stress experienced by many banks in the early 1990s, not only in the United States but in other countries as well.

Under the New Accord, SL loans financing the construction of one- to four-family residential properties (single or in subdivisions) are included with other ADC loans in the high asset correlation category. However, loans financing the construction of pre-sold one- to four-family residential properties would be eligible to be treated as low-asset-correlation CRE exposures. In some cases the loans may finance the construction of subdivisions or other groups of houses, some of which are pre-sold while others are not.

Under the New Accord, each national supervisory authority is directed to recognize and incorporate into its implementation of the New Accord the high asset correlation determinations of other national supervisory authorities for loans made in their respective jurisdictions. Thus, when the Agencies designate certain CRE properties as HVCRE, foreign banking organizations making extensions of credit to those properties also would be expected to treat them as HVCRE. Similarly, when non-U.S. supervisory authorities designate certain CRE as HVCRE, U.S. banking organizations that extend credit to those properties would be expected to treat them as HVCRE.

The Agencies invite the submission of empirical evidence regarding the (relative or absolute) asset correlations characterizing portfolios of ADC loans, as well as comments regarding the circumstances under which such loans would appropriately be categorized as HVCRE.

The Agencies also invite comment on the appropriateness of exempting from the high-asset-correlation category ADC loans with substantial equity or that are pre-sold or sufficiently pre-leased. The Agencies invite comment on what standard should be used in determining whether a property is sufficiently pre-leased when prevailing occupancy rates are unusually low.

The Agencies invite comment on whether high-asset-correlation treatment for one- to four-family residential construction loans is appropriate, or whether they should be included in the low-asset-correlation category. In cases where loans finance the construction of a subdivision or other group of houses, some of which are pre-sold while others are not, the Agencies invite comment regarding how the ''pre-sold'' exception should be interpreted.

The Agencies invite comment on the competitive impact of treating defined classes of CRE differently. What are commenters' views on an alternative approach where there is only one risk weight function for all CRE? If a single risk weight function for all CRE is considered, what would be the appropriate asset correlation to employ?

Lease Financings

Under the wholesale A–IRB framework, some lease financings require special consideration. A distinction is made for leases that expose the lessor to residual value risk, namely the risk of the fair value of the assets declining below the banking organization's estimate of residual risk at lease inception. If a banking organization has exposure to residual value risk, it would assign a 100 percent risk weight to the residual value amount and determine a risk-weighted asset equivalent for the lease's remaining net investment (net of residual value amount) using the same methodology as for any other wholesale exposure. The sum of these components would be the risk-weighted asset amount for a particular lease. Where a banking organization does not have exposure to residual value risk, the lease's net investment would be subject to a capital charge using the same methodology applied to any other wholesale exposure.

This approach would be used regardless of accounting classification as a direct finance, operating or leveraged lease. For leveraged leases, when the banking organization is the equity participant it would net the balance of the non-recourse debt against the discounted lease payment stream prior to applying the risk weight. If the banking organization is the debt participant, the exposure would be treated as any other wholesale exposure.

The Agencies are seeking comment on the wholesale A–IRB capital formulas and the resulting capital requirements. Would this approach provide a meaningful and appropriate increase in risk sensitivity in the sense that the results are consistent with alternative assessments of the credit risks associated with such exposures or the capital needed to support them? If not, where are there material inconsistencies?

Does the proposed A–IRB maturity adjustment appropriately address the risk differences between loans with differing maturities?

Retail Exposures: Definitions and Inputs

The second major exposure category in the A–IRB framework is the retail exposure category. This category encompasses the vast majority of credit exposures to individual consumers. The Agencies also are considering whether certain SME exposures should be eligible for retail A–IRB treatment. The retail exposure category has three distinct sub-categories: (1) Residential mortgages (and related exposures); (2) qualifying revolving exposures (QREs); and (3) other retail exposures. There are separate A–IRB capital formulas for each of these three sub-categories to reflect different levels of associated risk.

The Agencies propose that the residential mortgage exposure sub-category be defined to include loans secured by first or subsequent liens on one-to four-family residential properties, including term loans and revolving lines of credit secured by home equity. There would be no upper limit on the size of the exposure that could be included in the residential mortgage exposure sub-category, but the borrower would have to be an individual and the banking organization should generally manage the exposure as part of a pool of similar exposures. Residential mortgage exposures that are individually internally rated and managed similarly to commercial exposures, rather than managed and internally rated as pools, would be treated under the wholesale A–IRB framework.

The second sub-category of retail exposures is qualifying revolving exposures (QREs). The Agencies propose to define QREs as exposures to individuals that are revolving, unsecured, uncommitted, less than $100,000, and managed as part of a pool of similar exposures. In practice, QREs will include primarily exposures where customers' outstanding borrowings are permitted to fluctuate based on their own decisions to borrow and repay, up to a limit established by the banking organization. Most credit card exposures to individuals and overdraft lines on individual checking accounts would be QREs.

The third sub-category of retail exposures, other retail exposures, includes two types of exposures. First, it encompasses all exposures to individuals for non-business purposes that are generally managed as part of a pool of similar exposures and that do not meet the conditions for inclusion in the first two sub-categories of retail exposures. The Agencies are not proposing to establish a fixed upper limit on the size of exposures to individuals that are eligible for the other retail treatment. In addition, the Agencies are proposing that the other retail sub-category include certain SME exposures that are managed on a pool basis similar to retail exposures. These exposures could be to a company or to an individual. The Agencies are considering an individual borrower exposure threshold of $1 million for such exposures. For the purpose of assessing compliance with the individual borrower exposure threshold, the banking organization would aggregate all exposures to a particular borrower on a fully consolidated basis. Credit card accounts with balances between $100,000 and $1 million would be considered other retail exposures rather than QRE, even if the accounts are extended to or guaranteed by an individual and used exclusively for small business purposes.

The Agencies are interested in comment on whether the proposed $1 million threshold provides the appropriate dividing line between those SME exposures that banking organizations should be allowed to treat on a pooled basis under the retail A–IRB framework and those SME exposures that should be rated individually and treated under the wholesale A–IRB framework.

One of the most significant differences between the wholesale and retail A–IRB categories is that the risk inputs for retail exposures do not have to be assigned at the level of an individual exposure. The Agencies recognize that banking organizations typically manage retail exposures on a portfolio or pool basis, where each portfolio or pool contains exposures with similar risk characteristics. Therefore, a key characteristic of the retail A–IRB framework is that the risk inputs for retail exposures would be assigned to portfolios or pools of exposures rather than to individual exposures.

It is important to highlight that within each of the three sub-categories of retail exposures, the retail A–IRB framework is intended to provide banking organizations with substantial flexibility to use the retail portfolio segmentation that they believe is most appropriate for their activities. In determining how to group their retail exposures within each sub-category into portfolio segments for the purpose of assigning A–IRB risk inputs, the Agencies believe that banking organizations should use a segmentation approach that is consistent with their approach for internal risk assessment purposes and that classifies exposures according to predominant risk characteristics.

As general principles for segmentation, banking organizations should group exposures in each of the three retail sub-categories into portfolios or pools according to the sub-category's principal risk drivers, and would have to be able to demonstrate that the resultant segmentation effectively differentiates and rank orders risk and provides reasonably accurate and consistent quantitative estimates of PD, LGD, and EAD. With the exceptions noted below, the Agencies are not proposing that institutions must consider any particular risk drivers or employ any minimum number of portfolios or pools in any of the three retail sub-categories. The only specific limitations that the Agencies would propose in regard to the portfolio segmentation of retail exposures are (1) banking organizations generally would not be permitted to combine retail exposures from multiple countries into the same portfolio segment (because of differences in national legal systems and bankruptcy regimes), and (2) banking organizations would need to separately segment delinquent retail exposures.

The inputs to the retail A–IRB capital formulas differ slightly from the inputs to the wholesale A–IRB capital formulas. Measures of PD, LGD, and EAD remain important elements, but there is no M input to the retail A–IRB capital formulas. Rather, the retail A–IRB capital formulas implicitly incorporate average maturity effects in general, such as in the residential mortgage sub-category.

Aside from the applicable definition of default, discussed below, the definitions of PD, LGD, and EAD for retail exposures are generally equivalent to those for wholesale exposures. One additional element of potential flexibility for banking organizations in the retail context needs to be highlighted. The Agencies recognize that certain banking organizations that may qualify for the advanced approaches segment their retail portfolios for management purposes by EL, rather than by separately measuring PD and LGD, as required under the A–IRB framework. Therefore, the Agencies propose that banking organizations be permitted substantial flexibility in translating measures of EL into the requisite PD and LGD inputs. For non-revolving portfolio segments, EL generally would equal the product of PD and LGD, so that if a banking organization has an estimate of EL and either PD or LGD, it would be able to infer an estimate of the other required input.

In addition, the Agencies are proposing that if one or the other of PD and LGD did not tend to vary significantly across portfolio segments, the banking organization would be permitted to apply a general estimate of that input to multiple segments and to use that general estimate, together with segment-specific estimates of EL, to infer segment-specific estimates of the other required input. The Agencies note, however, that this proposal offers substantial flexibility to institutions and may, in fact, be overly flexible (for example, because LGDs on residential mortgages tend to be quite cyclical). For these loans, the above method of inferring PDs or LGDs from a long-run average EL would not necessarily result in PD being estimated as a long-run average, and LGD would not necessarily reflect the loss rate expected to prevail when default rates are high. Banking organizations using an EL approach to retail portfolio segmentation would have to ensure that the A–IRB capital requirement under this method is at least as conservative as a PD/LGD method in order to minimize any potential divergences between capital requirements computed under the PD/LGD approach versus an EL approach.

As in the wholesale A–IRB framework, a floor of 3 basis points (0.03 percent) applies to the PD estimates for all retail exposures (that is, the minimum PD is 3 basis points). In addition, for residential mortgage exposures other than those guaranteed by a sovereign government, a floor of 10 percent on the LGD estimate would apply, based on the view that LGDs during periods of high default rates are unlikely to fall below this level if measured appropriately. Along with the overall monitoring of the implementation of the advanced approaches and the determination whether to generally relax the floors established during the initial implementation phases (that is, the 90 and 80 percent floors discussed above), the Agencies intend to review the need to retain PD and LGD floors for retail exposures following the first two years of implementation of the A–IRB framework.

The Agencies are proposing the following data requirements for retail A–IRB. Banking organizations would have to have a minimum of five years of data history for PD, LGD, and EAD, and preferably longer periods so as to include a complete economic cycle. Banking organizations would not have to give equal weight to all historical factors if they can demonstrate that the more recent data are better predictors of the risk inputs. Also, banking organizations would have to have a minimum of three years of experience with their portfolio segmentation and risk management systems.

Definition of Default and Loss

The retail definition of default and loss being proposed by the Agencies differs significantly from that proposed for the wholesale portfolio. Specifically, the Agencies propose to use the definitions of loss recognition embodied in the Federal Financial Institutions Examination Council (FFIEC) Uniform Retail Credit Classification and Account Management Policy.[21] All residential mortgages and all revolving credits would be charged off, or charged down to the value of the property, after a maximum of 180 days past due; other credits would be charged off after a maximum of 120 days past due.

In addition, the Agencies are proposing to define a retail default to include the occurrence of any one of the three following events if it occurs prior to the respective 120- or 180-day FFIEC policy trigger: (1) A full or partial charge-off resulting from a significant decline in credit quality of the exposure; (2) a distressed restructuring or workout involving forbearance and loan modification; or (3) a notification that the obligor has sought or been placed in bankruptcy. Finally, for retail exposures (as opposed to wholesale exposures) the definition of default may be applied to a particular facility, rather than to the obligor. That is, default on one obligation would not require a banking organization to treat all other obligations of the same obligor as defaulted.

Undrawn Lines

The treatment of undrawn lines of credit, in particular those associated with credit cards, merits specific discussion. Banking organizations would be permitted to incorporate undrawn retail lines in one of two ways. First, banking organizations could

[21] The FFIEC Uniform Retail Credit Classification and Account Management Policy was issued on June 12, 2000. It is available on the FFIEC Web site at *www.FFIEC.gov.*

incorporate them into their EAD estimates directly, by assessing the likelihood that undrawn balances would be drawn at the time of an event of default. Second, banking organizations could incorporate them into LGD estimates by assessing the size of potential losses in default (including those arising from both currently drawn and undrawn balances) as a proportion of the current drawn balance. In the latter case, it is possible that the relevant LGD estimates would exceed 100 percent. While the proposed EAD approach for undrawn wholesale and retail lines is the same, the Agencies are aware that the sheer volume of credit card undrawn lines and the ratio of undrawn lines to outstanding balances create issues for undrawn retail lines that differ from undrawn wholesale lines not only in degree but also in kind.

An additional issue arises in connection with the undrawn lines associated with credit card accounts whose drawn balances (but not undrawn balances) have been securitized. To the extent that banking organizations remain exposed to the risk that such undrawn lines will be drawn, but such undrawn lines are not themselves securitized, then there is a need for institutions to hold regulatory capital against such undrawn lines. The Agencies propose that a banking organization would be required to hold capital against the full amount of any undrawn lines regardless of whether drawn amounts are securitized. This presumes that the institution itself is exposed to the credit risk associated with future draws.

The Agencies are interested in comments and specific proposals concerning methods for incorporating undrawn credit card lines that are consistent with the risk characteristics and loss and default histories of this line of business.

The Agencies are interested in further information on market practices in this regard, in particular the extent to which banking organizations remain exposed to risks associated with such accounts. More broadly, the Agencies recognize that undrawn credit card lines are significant in both of the contexts discussed above, and are particularly interested in views on the appropriate retail A–IRB treatment of such exposures.

Future Margin Income

In the New Accord, the retail A–IRB treatment of QREs includes a unique additional input that arises because of the large amount of expected losses typically associated with QREs. As noted above, the A–IRB approach would require banking organizations to hold regulatory capital against both EL and UL. Banking organizations typically seek to cover expected losses through interest income and fees for all of their business activities, and the Agencies recognize that this practice is a particularly important aspect of the business model for QREs.

The Agencies are including in this proposal, for the QRE sub-category only, that future margin income (FMI) be permitted to offset a portion of the A–IRB retail capital charge relating to EL. For this purpose, the Agencies propose to define the amount of eligible FMI for the QRE sub-category as the amount of income anticipated to be generated by the relevant exposures over the next twelve months that can reasonably be assumed to be available to cover potential credit losses on the exposures after covering expected business expenses, and after subtracting a cushion to account for potential volatility in credit losses (UL). FMI would not be permitted to include anticipated income from new accounts and would have to incorporate assumptions about income from existing accounts that are in line with the banking organization's historical experience. The amount of the cushion to account for potential volatility in credit losses would be set equal to two standard deviations of the banking organization's annualized loss rate on the exposures. The Agencies would expect banking organizations to be able to support their estimates of eligible FMI on the basis of historical data and would disallow the use of FMI in the QRE capital formula if this is not the case. The step needed to recognize eligible FMI is discussed below.

Permitting a FMI offset to the A–IRB capital requirement for QREs could have a significant impact on the level of minimum regulatory capital at institutions adopting the advanced approaches. The Agencies would need to fully assess and analyze the impact of such an FMI offset on institutions' risk-based capital ratios prior to final implementation of the A–IRB approach. Furthermore, the Agencies anticipate the need to issue additional guidance setting out more specific expectations in this regard.

For the QRE sub-category of retail exposures only, the Agencies are seeking comment on whether or not to allow banking organizations to offset a portion of the A–IRB capital requirement relating to EL by demonstrating that their anticipated FMI for this sub-category is likely to more than sufficiently cover EL over the next year.

The Agencies are seeking comment on the proposed definitions of the retail A–IRB exposure category and sub-categories. Do the proposed categories provide a reasonable balance between the need for differential treatment to achieve risk-sensitivity and the desire to avoid excessive complexity in the retail A–IRB framework? What are views on the proposed approach to inclusion of SMEs in the other retail category?

The Agencies are also seeking views on the proposed approach to defining the risk inputs for the retail A–IRB framework. Is the proposed degree of flexibility in their calculation, including the application of specific floors, appropriate? What are views on the issues associated with undrawn retail lines of credit described here and on the proposed incorporation of FMI in the QRE capital determination process?

The Agencies are seeking comment on the minimum time requirements for data history and experience with portfolio segmentation and risk management systems: Are these time requirements appropriate during the transition period? Describe any reasons for not being able to meet the time requirements.

Retail Exposures: Formulas

The retail A–IRB capital formulas are very similar to the wholesale A–IRB formulas, and are based on the same underlying concepts. However, because there is no M adjustment associated with the retail A–IRB framework, the retail A–IRB capital calculations generally involve fewer steps than the wholesale A–IRB capital calculations. As with the wholesale A–IRB framework, the output of the retail A–IRB formulas is a minimum capital requirement, expressed in dollars, for the relevant pool of exposures. The capital requirement would be converted into an equivalent amount of risk-weighted assets by multiplying the capital requirement by 12.5. The two key steps in implementing the retail A–IRB capital formulas are (1) assessing the relevant asset correlation parameter, and (2) calculating the minimum capital requirement for the relevant pool of exposures.

Residential Mortgages and Related Exposures

For residential mortgage and related exposures, the retail A–IRB capital formula requires only one step. This is because the asset correlation parameter for such exposures is fixed at 15 percent, regardless of the PD of any particular pool of exposures. The fixed asset correlation parameter reflects the Agencies' view that the arguments for linking the asset correlation to PD, as occurs in the wholesale A–IRB framework and in the other two sub-categories of retail exposures, are not as relevant for residential mortgage-related exposures, whose performance is significantly influenced by broader trends in the housing market for borrowers of all credit qualities. The assumed asset correlation of 15 percent also seeks implicitly to reflect the higher average maturity associated with residential mortgage exposures and is therefore higher than would likely be the case if a specific maturity adjustment were also included in the retail A–IRB framework. The proposed retail A–IRB capital formula for residential mortgage and related exposures is as follows:

K = EAD * LGD * N[1.08465 * G(PD) + 0.4201 * G(0.999)]

Where

K denotes the capital requirement;
EAD denotes exposure at default;
LGD denotes loss given default;
N(x) denotes the standard normal cumulative distribution function;
G(x) denotes the inverse of the standard normal cumulative distribution function; and
PD denotes probability of default.

The following table depicts a range of representative capital requirements (K) for residential mortgage and related exposures based on this formula. Three different illustrative LGD assumptions are shown: 15 percent, 35 percent, and 55 percent. For comparison purposes, the current capital requirement on most first mortgage loans is 4 percent and on most home equity loans is 8 percent.

CAPITAL REQUIREMENTS

[In percentage points]

PD	LGD		
	15 percent	35 percent	55 percent
0.05 percent	0.17	0.41	0.64
0.10 percent	0.30	0.70	1.10
0.25 percent	0.61	1.41	2.22
0.50 percent	1.01	2.36	3.70
1.00 percent	1.65	3.86	6.06
2.00 percent	2.64	6.17	9.70
5.00 percent	4.70	10.97	17.24
10.00 percent	6.95	16.22	25.49
20.00 percent	9.75	22.75	35.75

Subject to the caveats noted earlier, evidence from QIS3 suggested that advanced approach banking organizations would experience a reduction in credit risk capital requirements for residential mortgage exposures of about 56 percent.

Private Mortgage Insurance

The Agencies wish to highlight one issue associated with the A–IRB capital requirements for the residential mortgage sub-category relating to the treatment of private mortgage insurance (PMI). Most PMI arrangements effectively provide partial compensation to the banking organization in the event of a mortgage default. Accordingly, the Agencies consider that it may be appropriate for banking organizations to recognize such effects in the LGD estimates for individual mortgage portfolio segments, consistent with the historical loss experience on those segments during periods of high default rates. Such an approach would avoid requiring banking organizations to quantify specifically the effect of PMI on a loan-by-loan basis; rather, they could estimate the effect of PMI on an average basis for each segment. This approach effectively ignores the risk that the mortgage insurers themselves could default.

The Agencies seek comment on the competitive implications of allowing PMI recognition for banking organizations using the A–IRB approach but not allowing such recognition for general banks. In addition, the Agencies are interested in data on the relationship between PMI and LGD to help assess whether it may be appropriate to exclude residential mortgages covered by PMI from the proposed 10 percent LGD floor. The Agencies request comment on whether or the extent to which it might be appropriate to recognize PMI in LGD estimates.

More broadly, the Agencies are interested in information regarding the risks of each major type of residential mortgage exposure, including prime first mortgages, sub-prime mortgages, home equity term loans, and home equity lines of credit. The Agencies are aware of various views on the resulting capital requirements for several of these product areas, and wish to ensure that all appropriate evidence and views are considered in evaluating the A–IRB treatment of these important exposures.

The risk-based capital requirements for credit risk of prime mortgages could well be less than one percent of their face value under this proposal. The Agencies are interested in evidence on the capital required by private market participants to hold mortgages outside of the federally insured institution and GSE environment. The Agencies also are interested in views on whether the reductions in mortgage capital requirements on mortgage loans contemplated here would unduly extend the federal safety net and risk contributing to a credit-induced bubble in housing prices. In addition, the Agencies are also interested in views on whether there has been any shortage of mortgage credit under the general risk-based capital rules that would be alleviated by the proposed changes.

Qualifying Revolving Exposures

The second sub-category of retail exposures is QREs. The calculation of A–IRB capital requirements for QREs would require three steps: (1) Calculation of the relevant asset correlation parameter, (2) calculation of the minimum capital requirement assuming no offset for eligible FMI, and (3) application of the offset for eligible FMI. These steps would be performed for each QRE portfolio segment individually.

As in the case of wholesale exposures, it is assumed that the asset correlation for QREs declines as PD rises. This reflects the view that pools of borrowers with lower credit quality (higher PD) are less likely to experience simultaneous defaults than pools of higher credit quality (lower PD) borrowers, because with higher PD borrowers defaults are more likely to result from borrower-specific or idiosyncratic factors. In the case of QREs, the asset correlation approaches an upper bound value of 11 percent for very low PD values and approaches a lower bound value of 2 percent for very high PD values. The specific formula for determining the asset correlation parameter for QREs is as follows:

R = 0.02 * (1–EXP(−50 * PD)) + 0.11 * [1–(1–EXP(−50 * PD))]

Where

R denotes asset correlation;
EXP denotes the natural exponential function; and
PD denotes probability of default.

The second step in the A–IRB capital calculation for QREs would be the calculation of the capital requirement assuming no FMI offset. The specific formula to calculate this amount is as follows:

$K_{No\ FMI}$ = EAD * LGD * N[(1–R)∧−0.5 * G(PD) + (R/(1–R))∧0.5 * G(0.999)]

Where

$K_{No\ FMI}$ denotes the capital requirement assuming no FMI offset;
EAD denotes exposure at default;
LGD denotes loss given default;
N(x) denotes the standard normal cumulative distribution function;
R denotes asset correlation;
G(x) denotes the inverse of the standard normal cumulative distribution function; and
PD denotes probability of default.

Future Margin Income Adjustment

The result of this calculation effectively includes both an EL and a UL component. As already discussed, for QREs only, the Agencies are considering the possibility of allowing institutions to offset a portion of the EL portion of the capital requirement using eligible FMI. Up to 75 percent of the EL portion of the capital requirement could potentially be offset in this fashion. The specific calculation for determining the capital requirement (K) after application of the potential offset for eligible FMI is as follows.

K = $K_{No\ FMI}$ − eligible FMI offset

Where

K denotes the capital requirement after application of an offset for eligible FMI;
$K_{No\ FMI}$ denotes the capital requirement assuming no FMI offset;
Eligible FMI offset equals:
0.75 * EL if estimated FMI equals or exceeds the expected 12-month loss amount plus two standard deviations of the annualized loss rate, or zero otherwise;
EL denotes expected loss (EL = EAD * PD * LGD);
FMI denotes future margin income;
EAD denotes exposure at default;
PD denotes probability of default; and
LGD denotes loss given default.

If eligible FMI did not exceed the required minimum, then recognition of eligible FMI would be disallowed.

The Agencies are interested in views on whether partial recognition of FMI should be permitted in cases where the amount of eligible FMI fails to meet the required minimum. The Agencies also are interested in views on the level of portfolio segmentation at which it would be appropriate to perform the FMI calculation. Would a requirement that FMI eligibility calculations be performed separately for each portfolio segment effectively allow FMI to offset EL capital requirements for QREs?

The following table depicts a range of representative capital requirements (K) for QREs based on these formulas. In each case, it is assumed that the maximum offset for eligible FMI has been applied. The LGD is assumed to equal 90 percent, consistent with recovery rates for credit card portfolios. The table shows capital requirements with recognition of FMI and without recognition of FMI but using the same formula in other respects. As PDs increase, the proportion of total required capital held against EL after deducting the 75 percent offset rises at an increasing rate and the proportion held against UL declines at an increasing rate. Offsets from EL, as considered in this ANPR, would therefore have a proportionally greater impact on reducing required capital charges as default probabilities increase. For comparison purposes, the current capital requirement on drawn credit card exposures is 8 percent and is zero for undrawn credit lines.

CAPITAL REQUIREMENT

[In percentage points]

PD	With FMI capital 8%	Without FMI capital 8%
0.05	0.68	0.72
0.10	1.17	1.23
0.25	2.24	2.41
0.50	3.44	3.78
1.00	4.87	5.55
2.00	6.21	7.56
5.00	7.89	11.27
10.0	11.12	17.87
20.0	17.23	30.73

Subject to the same qualifications mentioned earlier, the QIS3 results estimated an increase in credit risk capital requirements for QREs of about 16 percent.

Other Retail Exposures

The third and final sub-category of retail A–IRB exposures is other retail exposures. This sub-category encompasses a wide variety of different exposures including auto loans, student loans, consumer installment loans, and some SME loans. Two steps would be required to calculate the A–IRB capital requirement for other retail exposures: (1) Calculating the relevant asset correlation parameter, and (2) calculating the capital requirement. Both of these steps would be done separately for each portfolio segment included within the other retail sub-category.

As for wholesale exposures and QREs, the asset correlation parameter for other retail exposures declines as PD rises. In the case of other retail exposures, the asset correlation parameter approaches an upper bound value of 17 percent for very low PD values and approaches a lower bound value of 2 percent for very high PD values. The specific formula for determining the asset correlation for other retail exposures is as follows:

R = 0.02 * (1 − EXP(− 35 * PD)) + 0.17 * [1 − (1 − EXP(− 35 * PD))]

Where

R denotes asset correlation;
EXP denotes the natural exponential function; and
PD denotes probability of default.

The second step in the A–IRB capital calculation for other retail exposures would be the calculation of the capital requirement (K). The specific formula to calculate this amount is as follows:

K = EAD * LGD * N[(1 − R)∧ − 0.5 * G(PD) + (R / (1 − R))∧0.5 * G(0.999)]

Where

K denotes the capital requirement;
EAD denotes exposure at default;
LGD denotes loss given default;
PD denotes probability of default;
N(x) denotes the standard normal cumulative distribution function;
G(x) denotes the inverse of the standard normal cumulative distribution function; and
R denotes asset correlation.

The following table depicts a range of representative capital requirements (K) for other retail exposures based on this formula. Three different LGD assumptions are shown—25 percent, 50 percent, and 75 percent—in order to depict a range of potential outcomes depending on the characteristics of the underlying retail exposure. For comparison purposes, the current capital requirement on most of the exposures likely to be included in the other retail sub-category is 8 percent.

CAPITAL REQUIREMENTS

[In percentage points]

PD	LGD		
	25 percent	50 percent	75 percent
0.05 percent	0.33	0.66	0.99

CAPITAL REQUIREMENTS—Continued
[In percentage points]

PD	LGD		
	25 percent	50 percent	75 percent
0.10 percent	0.56	1.11	1.67
0.25 percent	1.06	2.13	3.19
0.50 percent	1.64	3.28	4.92
1.00 percent	2.35	4.70	7.05
2.00 percent	3.08	6.15	9.23
5.00 percent	3.94	7.87	11.81
10.00 percent	5.24	10.48	15.73
20.00 percent	8.55	17.10	25.64

Subject to the qualifications described earlier, QIS3 estimated a 25 percent reduction in credit risk-based capital requirements for the other retail category.

The Agencies are seeking comment on the retail A–IRB capital formulas and the resulting capital requirements, including the specific issues mentioned. Are there particular retail product lines or retail activities for which the resulting A–IRB capital requirements would not be appropriate, either because of a misalignment with underlying risks or because of other potential consequences?

A–IRB: Other Considerations

As described earlier, the A–IRB capital requirement includes components to cover both EL and UL. Because banking organizations have resources other than capital to cover EL, the Agencies propose to recognize certain of these measures as potential offsets to the A–IRB capital requirement, subject to the limitations set forth below. The use of eligible FMI for QREs is one such potential mechanism that has already been discussed.

Loan Loss Reserves

A second important mechanism involves the allowance for loan and lease losses (ALLL), also referred to as general loan loss reserves. Under the general risk-based capital rules, an amount of the ALLL is eligible for inclusion as an element of Tier 2 capital, up to a limit equal to 1.25 percent of gross risk-weighted assets. Loan loss reserves above this limit are deducted from risk-weighted assets, on a dollar-for-dollar basis. The New Accord proposes to retain the 1.25 percent limit on the eligibility of loan loss reserves as an element of Tier 2 capital. However, the New Accord also contains, and the Agencies are proposing for comment, a feature that would allow the amount of the ALLL (net of associated deferred tax) above this 1.25 percent limit to be used to offset the EL portion of A–IRB capital requirements in certain circumstances.

The offset would be limited to that amount of EL that exceeds the 1.25 percent limit. For example, if the 1.25 percent limit equals $100, the ALLL equals $125, and the EL portion of the A–IRB capital requirement equals $110, then $10 of the capital requirement may be directly offset ($110 − $100). The additional amount of the ALLL not included in Tier 2 capital and not included as a direct offset against the A–IRB capital requirement ($125 − $110 = $15 in the example) would continue to be deducted from risk-weighted assets.

It is important to recognize that this treatment would likely result in a significantly more favorable treatment of such excess ALLL amounts than simply deducting them from risk-weighted assets. Under the proposal, banking organizations would be allowed to multiply the eligible excess ALLL by a factor of 12.5 because the minimum total capital requirement is 8 percent of risk-weighted assets. In effect, this treatment is 12.5 times more favorable than the treatment contained in the general risk-based capital rules, which allow only a deduction against risk-weighted assets on a dollar-for-dollar basis. In addition, it is important to note that a dollar-for-dollar offset against the A–IRB capital requirement is also more favorable than the inclusion of ALLL below the 1.25 percent limit in Tier 2 capital, because the latter has no impact on Tier 1 capital ratios, while the former does.

The Agencies recognize the existence of various issues in regard to the proposed treatment of ALLL amounts in excess of the 1.25 percent limit and are interested in views on these subjects, as well as related issues concerning the incorporation of expected losses in the A–IRB framework and the treatment of the ALLL generally. Specifically, the Agencies invite comment on the domestic competitive impact of the potential difference in the treatment of reserves described above.

Another issue the Agencies wish to highlight is the inclusion within the New Accord of the ability for banking organizations to make use of ‘‘general specific’’ provisions as a direct offset against EL capital requirements. Such provisions are not specific to particular exposures but are specific to particular categories of exposures and are not allowed as an element of Tier 2 capital. While several other countries make use of such provisions, the Agencies do not believe existing elements of the ALLL in the United States qualify for such treatment.

The Agencies seek views on this issue, including whether the proposed U.S. treatment has significant competitive implications. Feedback also is sought on whether there is an inconsistency in the treatment of general specific provisions (all of which may be used as an offset against the EL portion of the A–IRB capital requirement) in comparison to the treatment of the ALLL (for which only those amounts of general reserves exceeding the 1.25 percent limit may be used to offset the EL capital charge).

Charge-Offs

Another potential offset to the EL portion of the A–IRB capital requirements is the use of partial charge-offs, where a portion of an individual exposure is written off. Given the A–IRB definition of default, a partial charge-off would cause an exposure to be classified as a defaulted exposure (that is, PD=100%), in which case the A–IRB capital formulas ensure that the resulting capital requirement on the defaulted exposure is equal to EAD * LGD, where EAD is defined as the gross exposure amount prior to the partial charge-off. All of this capital requirement can be considered to be covering EL.

The New Accord proposes that for such partially charged-off exposures, the banking organization be allowed to use the amount of the partial charge-off to offset the EL component of that asset's capital charge on a dollar-for-dollar basis. In addition, to the extent that the partial charge-off on a defaulted exposure exceeds the EL capital charge on that exposure, the amount of this surplus could be used to offset the EL capital charges on other defaulted assets in the same portfolio (for example, corporates, banks, residential mortgages, *etc.*), but not for any other purpose.

An implication of this aspect of the New Accord is that if a defaulted loan's charge-off were at least equal to its expected loss, no additional capital requirement would be incurred on that exposure. For example, consider a $100 defaulted exposure having an LGD of 40 percent, implying an expected loss of $40, equal to the IRB capital charge. If the charge-off were equal to $40, under the New Accord approach, there would be no additional capital required against the resultant $60 net position. The Agencies do not believe this is a prudent or acceptable outcome, since this position is not riskless and a banking organization could be forced to recognize additional charge-offs if the recoveries turn out to be less than expected.

To prevent this possibility, the Agencies propose that, for defaulted exposures, the A–IRB capital charge (inclusive of any EL offsets for charge-offs) be calculated as the sum of (a) EAD * LGD less any charge-offs and (b) 8 percent of the carrying value of the loan (that is, the gross exposure amount (EAD) less any charge-offs).

Also, the charged off amounts in excess of the EAD * LGD product would not be permitted to offset the EL capital requirements for other exposures. In effect, the proposed A–IRB capital charge on a defaulted exposure adds a buffer for defaulted assets and results in a floor equal to 8 percent of the remaining book value of the exposure if the banking organization has taken a charge-off equal to or greater than the EAD * LGD. Importantly, this treatment would not apply to a defaulted exposure that has been restructured and where the obligor has not yet defaulted on the restructured credit. Upon any restructuring, whether associated with a default or otherwise, the A–IRB capital charge would be based on the EAD, PD, LGD, and M applicable to the exposure after it has been restructured. The existence of any partial charge-offs associated with the pre-restructured credit would affect the A–IRB capital charge on the restructured exposure only through its impact on the post-restructured exposure's EAD, PD, and/or LGD.

Purchased Receivables

This section describes the A–IRB treatment for wholesale and retail credit exposures acquired from another institution (purchased receivables). The purchase of such receivables may expose the acquiring banking organization to potential losses from two sources: credit losses attributable to defaults by the underlying receivables obligors, and losses attributable to dilution of the underlying receivables.[22] The total A–IRB capital requirement for purchased receivables would be the sum of (a) a capital charge for credit risk, and (b) a separate capital charge for dilution risk, when dilution is a material factor.

Capital Charge for Credit Risk

The New Accord's proposed treatment of purchased loans would treat a purchase discount as equivalent to a partial charge-off, and for this reason it could imply a zero capital charge against certain exposures. In general, a zero capital charge would emerge whenever the difference between a loan's face value and purchase price (the purchase discount) was greater than or equal to its LGD, as might be the case with a secondary market purchase of deeply distressed debt. Again, the Agencies believe that a zero capital charge in such a circumstance is unwarranted because the position is not riskless.

The Agencies propose that for a credit exposure that is purchased or acquired from another party, the A–IRB capital charge would be calculated as if the exposure were a direct loan to the underlying obligor in the amount of the loan's carrying value to the purchasing banking organization with other attributes of the loan agreement (for example, maturity, collateral, covenants) and, hence, LGD, remaining unchanged. This treatment would apply regardless of whether the carrying value to the purchasing banking organization was less than, equal to, or greater than the underlying instrument's face value. Thus, if a loan having a principal amount equal to $100 and associated PD and LGD of 10 percent and 40 percent was purchased for $80, the capital charge against the purchased loan would be calculated as if that loan had an EAD equal to $80, PD equal to 10 percent, and LGD equal to 40 percent.

In general, the same treatment would apply to pools of purchased receivables. However, under the conditions detailed below, an alternative top-down approach (similar to that used for retail exposures) may be applied to pools of purchased receivables if the purchasing banking organization can only estimate inputs to the capital function (PD, LGD, EAD, and M) on a pool or aggregate basis.

Top-Down Method for Pools of Purchased Receivables

Under the top-down approach, required capital would be determined using the appropriate A–IRB capital formula (that is, for wholesale exposures, the wholesale capital function, and for retail exposures, the appropriate retail capital function) in combination with estimates of PD, LGD, EAD, and M developed for pools of receivables. In estimating the pool parameters, the banking organization first would determine EL for the purchased receivables pool, expressed (in decimal form) at an annual rate relative to the amount currently owed to the banking organization by the obligors in the receivables pool. The estimated EL would not take into account any assumptions of recourse or guarantees from the seller of the receivables or other parties. If the banking organization can decompose EL into PD and LGD components, then it would do so and use those components as inputs into the capital function. If the institution cannot decompose EL, then it would use the following split: PD would equal the estimated EL, and LGD would be 100 percent. Under the top-down approach, EAD would equal the carrying amount of the receivables and for wholesale exposures, M would equal the exposure-weighted average effective maturity of the receivables in the pool.[23]

Treatment of Undrawn Receivables Purchase Commitments

Capital charges against any undrawn portions of receivables purchase facilities ('undrawn purchase commitments') also would be calculated using the top-down methodology. The EL (and/or PD and LGD) parameters would be determined on the basis of the current pool of eligible receivables using the pool-level estimation methods described above. For undrawn commitments under revolving purchase facilities, the New Accord specifies that the EAD would be set at 75 percent of the undrawn line. This treatment reflects a concern that relevant

[22] Dilution refers to the possibility that the contractual amounts payable by the receivables obligors may be reduced through future cash or non-cash credits to the accounts of these obligors. Examples include offsets or allowances arising from returns of goods sold, disputes regarding product quality, possible debts of the originator/seller to a receivables obligor, and any payment or promotional discounts offered by the originator/seller (for example, a credit for cash payments within 30 days).

[23] If a banking organization can estimate the exposure-weighted average size of the pool it also would use the firm-size adjustment (S) in the wholesale framework.

historical data for estimating such EADs reliably is not available at many banking organizations. For other undrawn purchase commitments, EAD would be estimated by the banking organization providing the facility and would be subject to the same operational standards that are applicable to undrawn wholesale credit lines. The level of M associated with undrawn purchase commitments would be the average effective maturity of receivables eligible for purchase from that seller, so long as the facility contains effective arrangements for protecting the banking organization against an unanticipated deterioration. In the absence of such protections, the M for an undrawn commitment would be calculated as the sum of (a) the longest-dated potential receivable under the purchase agreement, and (b) the remaining maturity of the facility.

The Agencies seek comment on the proposed methods for calculating credit risk capital charges for purchased receivables. Are the proposals reasonable and practicable?

For committed revolving purchase facilities, is the assumption of a fixed 75 percent conversion factor for undrawn lines reasonable? Do banking organizations have the ability (including relevant data) to develop their own estimate of EADs for such facilities? Should banking organizations be permitted to employ their own estimated EADs, subject to supervisory approval?

A banking organization may only use the top-down approach with approval of its primary Federal supervisor. In addition, the purchased receivables would have to have been purchased from unrelated, third party sellers and the organization may not have originated the credit exposures either directly or indirectly. The receivables must have been generated on an arm's length basis between the seller and the obligor (intercompany accounts receivable and receivables subject to contra-accounts between firms that buy and sell to each other would not qualify). Also, the receivables may not have a remaining maturity of greater than one year, unless they are fully secured. The Agencies propose that the bottom-up method would have to be used for receivables to any single obligor, or to any group of related obligors, that aggregate to more than $1 million.

Capital Charge for Dilution Risk

When dilution is a material risk factor,[24] purchased receivables would be subject to a separate capital charge for that risk. The dilution capital charge may be calculated at the level of each individual receivable and then aggregated, or, for a pool of receivables, at the level of the pool as a whole. The capital charge for dilution risk would be calculated using the wholesale A–IRB formula and the following parameters: EAD would be equal to the gross amount of receivable(s) balance(s); LGD would be 100 percent; M would be the (exposure weighted-average) effective remaining maturity of the exposure(s); and PD would be the expected dilution loss rate, defined as total expected dilution losses over the remaining term of the receivable(s) divided by EAD.[25] Expected dilution losses would be computed on a stand-alone basis; that is, under the assumption of no recourse or other support from the seller or third-party guarantors.

The following table illustrates the dilution risk capital charges (per dollar of EAD) implied by this approach for a hypothetical pool of purchased receivables having a remaining maturity of one year or less. As can be seen, the proposal implies capital charges for dilution risk that are many multiples of expected dilution losses.

CAPITAL REQUIREMENTS

[In percentage points]

Expected dilution loss rate	Dilution risk capital charge (per dollar of EAD, percent)
0.05 percent	2.05
0.10 percent	3.42
0.25 percent	6.41
0.50 percent	9.77
1.00 percent	14.03
2.00 percent	19.03
5.00 percent	28.45
10.00 percent	41.24

The Agencies seek comment on the proposed methods for calculating dilution risk capital requirements. Does this methodology produce capital charges for dilution risk that seem reasonable in light of available historical evidence? Is the wholesale A–IRB capital formula appropriate for computing capital charges for dilution risk?

In particular, is it reasonable to attribute the same asset correlations to dilution risk as are used in quantifying the credit risks of wholesale exposures within the A–IRB framework? Are there alternative method(s) for determining capital charges for dilution risk that would be superior to that set forth above?

Minimum Requirements

The Agencies propose to apply standards for the estimation of risk inputs and expected dilution losses and for the control and risk management systems associated with purchased receivables programs that are consistent with the general guidance contained in the New Accord. These standards will aim to ensure that risk input and expected dilution loss estimates are reliable and consistent over time, and reflect all relevant information that is available to the acquiring banking organization. The minimum operational requirements are intended to ensure that the acquiring banking organization has a valid legal claim to cash proceeds generated by the receivables pool, that the pool and cash proceeds are closely monitored and controlled, and that systems are in place to identify and address seller, servicer, and other potential risks. A more detailed discussion of these requirements will be provided when the Agencies release draft examination guidance dealing with purchased receivables programs.

The Agencies seek comment on the appropriate eligibility requirements for using the top-down method. Are the proposed eligibility requirements, including the $1 million limit for any single obligor, reasonable and sufficient?

The Agencies seek comment on the appropriate requirements for estimating expected dilution losses. Is the guidance set forth in the New Accord reasonable and sufficient?

Risk Mitigation

For purposes of reducing the capital charges for credit risk or dilution risk with respect to purchased receivables, purchase discounts, guarantees, and other risk mitigants may be recognized through the same framework used elsewhere in the A–IRB approach.

Credit Risk Mitigation Techniques

The New Accord takes account of the risk-mitigating effects of both financial and nonfinancial collateral, as well as guarantees, including credit derivatives. For these risk mitigants to be recognized for regulatory capital purposes, the banking organization must have in place operational procedures and risk management processes that ensure that all documentation used in collateralizing or guaranteeing a transaction is binding on all parties and legally enforceable in all relevant jurisdictions. The banking organization must have conducted sufficient legal review to verify this conclusion, must have a well-founded legal basis for the conclusion, and must reconduct such a review as necessary to ensure continuing enforceability.

[24] If dilution risk is immaterial there would be no additional capital charge.

[25] If the remaining term exceeds one year, the expected dilution loss rate would be specified at an annual rate.

Adjusting LGD for the Effects of Collateral

A banking organization would be able to take into account the risk-mitigating effect of collateral in its internal estimates of LGD, provided the organization has established internal requirements for collateral management, operational procedures, legal certainty, and risk management processes that ensure that:

(1) The legal mechanism under which the collateral is pledged or transferred ensures that the banking organization has the right to liquidate or take legal possession of the collateral in a timely manner in the event of the default, insolvency, or bankruptcy (or other defined credit event) of the obligor and, where applicable, the custodian holding the collateral;

(2) The banking organization has taken all steps necessary to fulfill legal requirements to secure the organization's interest in the collateral so that it has and maintains an enforceable security interest;

(3) The banking organization has clear and robust procedures for the timely liquidation of collateral to ensure observation of any legal conditions required for declaring the default of the borrower and prompt liquidation of the collateral in the event of default;

(4) The banking organization has established procedures and practices for (i) conservatively estimating, on a regular ongoing basis, the market value of the collateral, taking into account factors that could affect that value (for example, the liquidity of the market for the collateral and obsolescence or deterioration of the collateral), and (ii) where applicable, periodically verifying the collateral (for example, through physical inspection of collateral such as inventory and equipment); and

(5) The banking organization has in place systems for requesting and receiving promptly additional collateral for transactions whose terms require maintenance of collateral values at specified thresholds.

In reflecting collateral in the LGD estimate, the banking organization would need to consider the extent of any dependence between the risk of the borrower and that of the collateral or collateral provider. The banking organization's assessment of LGD would have to address in a conservative way any significant degrees of dependence, as well as any currency mismatch between the underlying obligation and the collateral. The LGD estimates would have to be grounded in historical recovery rates on the collateral and could not be based solely upon the collateral's estimated market value.

Repo-Style Transactions Subject to Master Netting Agreements

Repo-style transactions include reverse repurchase agreements and repurchase agreements and securities lending and borrowing transactions, including those executed on an indemnified agency basis.[26] Many of these transactions are conducted under a bilateral master netting agreement or equivalent arrangement. The effects of netting arrangements generally would be recognized where the banking organization takes into account the risk-mitigating effect of collateral through an adjustment to EAD. To qualify for the EAD adjustment treatment, the repo-style transaction would have to be marked-to-market daily and be subject to a daily margin maintenance requirement. Further, the repo-style transaction would have to be documented under a qualifying master netting agreement that would have to:

(1) Provide the non-defaulting party the right to terminate and close out promptly all transactions under the agreement upon an event of default, including in the event of insolvency or bankruptcy of the counterparty;

(2) Provide for the netting of gains and losses on transactions (including the value of any collateral) terminated and closed out under the agreement so that a single net amount is owed by one party to the other;

(3) Allow for the prompt liquidation or setoff of collateral upon the occurrence of an event of default; and

(4) Be, together with the rights arising from the provisions required in (1) to (3) above, legally enforceable in each relevant jurisdiction upon the occurrence of an event of default and regardless of the counterparty's insolvency or bankruptcy.

Where a banking organization's repo-style transactions do not meet these requirements, it would not be able to use the EAD adjustment method. Rather, for each individual repo-style transaction it would estimate an LGD that takes into account the collateral received. It would use the notional amount of the transaction for EAD; it would not take into account netting effects for purposes of determining either EAD or LGD.

[26] Some banking organizations, particularly those that are custodians, lend, as agent, their customers' securities on a collateralized basis. Typically, the agent banking organization indemnifies the customer againts risk of loss in the event the borrowing counterparty defaults. Where such indemnites are provided, the agent banking organization has the same risks it would have if it had entered into the transaction as principal.

The method for determining EAD for repo-style transactions, described below, is essentially the determination of an unsecured loan equivalent exposure amount to the counterparty. Thus, no collateral effects for these transactions would be recognized through LGD; rather, the applicable LGD would be the one the banking organization would estimate for an unsecured exposure to the counterparty.

To determine EAD, the banking organization would add together its current exposure to the counterparty under the master netting arrangement and a measure for PFE to the counterparty under the master netting arrangement. The current exposure would be the sum of the market values of all securities and cash lent, sold subject to repurchase, or pledged as collateral to the counterparty under the master netting agreement, less the sum of the market values of all securities and cash lent, sold subject to repurchase, or pledged as collateral by the counterparty. The PFE calculation would be based on the market price volatilities of the securities delivered to, and the securities received from, the counterparty, as well as any foreign exchange rate volatilities associated with any cash or securities delivered or received.

Banking organizations would use a VaR-type measure for determining PFE for repo-style transactions subject to master netting agreements. Banking organizations would be required to use a 99th percentile, one-tailed confidence interval for a five-day holding period using a minimum one-year historical observation period of price data. Banking organizations would have to update their data sets no less frequently than once every three months and reassess them whenever market prices are subject to material changes. The illiquidity of lower-quality instruments would have to be taken into account through an upward adjustment in the holding period where the five-day holding period would be inappropriate given the instrument's liquidity. No particular model would be prescribed for the VaR-based measure, but the model would have to capture all material risks for included transactions.

Banking organizations using a VaR-based approach to measuring PFE would be permitted to take into account correlations in the price volatilities among instruments delivered to the counterparty, among instruments received from the counterparty, as well as between the two sets of instruments. The VaR-based approach for calculating PFE for repo-style transactions would be available to all banking organizations that received supervisory approval for an internal market risk model under the market risk capital rules. Other banking organizations could apply separately for supervisory approval to use their internal VaR models for calculation of PFE for repo-style transactions.

A banking organization would use the following formula to determine EAD for each counterparty with which it has a master netting agreement for repo-style transactions.

EAD = max {0, [($\boldsymbol{\Sigma}$ E − $\boldsymbol{\Sigma}$C) + (VaR output from internal market risk model × multiplier)]}

Where:

E denotes the current value of the exposure (that is, all securities and cash delivered to the counterparty); and

C denotes the current value of the collateral received (that is, all securities and cash received from the counterparty).

The multiplier in the above formula would be determined based on the results of the banking organization's backtesting of the VaR output. To backtest the output, the banking organization would be required to identify on an annual basis twenty counterparties that include the ten largest as determined by the banking organization's own exposure measurement approach and ten others selected at random. For each day and for each of the twenty counterparties, the banking organization would compare the previous day's VaR estimate for the counterparty portfolio to the change in the current exposure of the previous day's portfolio. This change represents the difference between the net value of the previous day's portfolio using today's market prices and the net value of that portfolio using the previous day's market prices. Where this difference exceeds the previous day's VaR estimate, an exception would have occurred.

At the end of each quarter, the banking organization would identify the number of exceptions it has observed for its twenty counterparties over the most recent 250 business days, that is, the number of exceptions in the most recent 5000 observations. Depending on the number of exceptions, the output of the VaR model would be scaled up using a multiplier as provided in the table below.

Zone	Number of exceptions	Multiplier
Green Zone ...	0–99	None (=1)
Yellow Zone ..	100–119	2.0
	120–139	2.2
	140–159	2.4
	160–179	2.6
	180–199	2.8
Red Zone	200 or more ..	3.0

The Agencies seek comments on the methods set forth above for determining EAD, as well as on the proposed backtesting regime and possible alternatives banking organizations might find more consistent with their internal risk management processes for these transactions. The Agencies also request comment on whether banking organizations should be permitted to use the standard supervisory haircuts or own estimates haircuts methodologies that are proposed in the New Accord.

Guarantees and Credit Derivatives

The Agencies are proposing that banking organizations reflect the credit risk mitigating effects of guarantees and credit derivatives through adjusting the PD or the LGD estimate (but not both) of the underlying obligation that is protected. The banking organization would be required to assign the borrower and guarantor to an internal rating in accordance with the minimum requirements set out for unguaranteed (unhedged) exposures, both prior to the adjustments and on an ongoing basis. The organization also would be required to monitor regularly the guarantor's condition and ability and willingness to honor its obligation. For guarantees on retail exposures, these requirements would also apply to the assignment of an exposure to a pool and the estimation of the PD of the pool.

For purposes of reflecting the effect of guarantees in regulatory capital requirements, the Agencies are proposing that a banking organization have clearly specified criteria for adjusting internal ratings or LGD estimates—or, in the case of retail exposures, for allocating exposures to pools to reflect use of guarantees and credit derivatives—that take account of all relevant information. The adjustment criteria would have to require a banking organization to (i) meet all minimum requirements for an unhedged exposure when assigning borrower or facility ratings to guaranteed/hedged exposures; (ii) be plausible and intuitive; (iii) consider the guarantor's ability and willingness to perform under the guarantee; (iv) consider the extent to which the guarantor's ability and willingness to perform and the borrower's ability to repay may be correlated (that is, the degree of wrong-way risk); and (v) consider the payout structure of the credit protection and conservatively assess its effect on the level and timing of recoveries. The banking organization also would be required to consider any residual risk to the borrower that may remain—for example, a currency mismatch between the credit protection and the underlying exposure.

Banking organizations would be required to make adjustments to alter PD or LGD estimates in a consistent way for a given type of guarantee or credit derivative. In all cases, the adjusted risk weight for the hedged obligation could not be less than the risk weight associated with a comparable direct exposure on the protection provider. As a practical matter, this guarantor risk weight floor on the risk weight of the hedged obligation would require a banking organization first to determine the risk weight on the hedged obligation using the adjustment it has made to the PD or LGD estimate to reflect the hedge. The banking organization would then compare that risk weight to the risk weight assigned to a direct obligation of the guarantor. The higher of the two risk weights would then be used to determine the risk-weighted asset amount of the hedged obligation.

Notwithstanding the guarantor risk weight floor, the proposed approach gives institutions a great deal of flexibility in their methodology for recognizing the risk-reducing effects of guarantees and credit derivatives. At the same time, the approach does not differentiate between various types of guarantee structures, which may have widely varying characteristics, that a banking organization may use. For example, a company to company guarantee, such as a company's guarantee of an affiliate or a supplier, is fundamentally different from a guarantee obtained from an unrelated third party that is in the business of extending financial guarantees. Examples of the latter type of guarantee include standby letters of credit, financial guarantee insurance, and credit derivatives. These products tend to be standardized across institutions and, thus, arguably should be recognized for capital purposes in a consistent fashion across institutions. The problem of inconsistent treatment could be exacerbated in the case of protection in the form of credit derivatives, which are tradable and which further can be distinguished by their characteristic of allowing a banking organization to have a recovery claim on two parties, the obligor and the derivative counterparty, rather than just one.

Industry comment is sought on whether a more uniform method of adjusting PD or LGD estimates should be adopted for various types of guarantees to minimize inconsistencies in treatment across institutions and, if so, views on what methods would best reflect industry practices. In this regard, the Agencies would be particularly interested in information on how banking organizations are currently treating various forms of guarantees within their economic capital allocation systems and the methods used to adjust PD, LGD, EAD, and any combination thereof.

Double Default Effects

The Agencies are proposing that neither the banking organization's criteria nor rating process for guaranteed/hedged exposures be allowed to take into account so-called ''double default'' effects—that is, the joint probability of default of the borrower and guarantor. As a result of not being able to recognize double default probabilities, the adjusted risk weight for the hedged obligation could not be less than the risk weight associated with a direct exposure on the protection provider. The Agencies are seeking comment on the proposed nonrecognition of double default effects. On June 10, 2003, the Federal Reserve released a white paper on this issue entitled, ''Treatment of Double Default and Double Recovery Effects for Hedged Exposures Under Pillar I of the Proposed New Basel Capital Accord.'' Commenters are encouraged to take into account the white paper in formulating their responses to the ANPR.

The Agencies also are interested in obtaining commenters' views on alternative methods for giving recognition to double default effects in a manner that is operationally feasible and consistent with safety and soundness. With regard to the latter, commenters are requested to bear in mind the concerns outlined in the double default white paper, particularly in connection with concentrations, wrong-way risk (especially in stress periods), and the potential for regulatory capital arbitrage. In this regard, information is solicited on how banking organizations consider double default effects on credit protection arrangements in their economic capital calculations and for which types of credit protection arrangements they consider these effects.

Requirements for Recognized Guarantees and Credit Derivatives

The Agencies are not proposing any restrictions on the types of eligible guarantors or credit derivative providers. Rather, a banking organization would be required to have clearly specified criteria for those guarantors they will accept as eligible for regulatory capital purposes. It is proposed that guarantees and credit derivatives recognized for regulatory capital purposes: (1) Be required to represent a direct claim on the protection provider; (2) explicitly reference specific exposures or classes thereof; (3) be evidenced in writing through a contract that is irrevocable by the guarantor; (4) not have a clause that would (i) allow the protection provider unilaterally to cancel the credit protection (other than in the event of nonpayment or other default by the protection buying banking organization) or (ii) increase the effective cost of credit protection as the credit quality of the underlying obligor deteriorates; (5) be in force until the underlying obligation is satisfied in full (to the amount and tenor of the guarantee); and (6) be legally enforceable against the guarantor in a jurisdiction where the guarantor has assets to attach and enforce a judgment.

The Agencies view the risk mitigating benefits of conditional guarantees—that is, guarantees that prescribe certain conditions under which the guarantor would not be obliged to perform—as particularly difficult to quantify. The Agencies are proposing that as a general matter such guarantees would not be recognized under the A–IRB approach. In certain circumstances, however, conditional guarantees could be recognized where the banking organization can demonstrate that its assignment criteria fully reflect the reduction in credit risk mitigation arising from the conditionality and that the guarantee provides a meaningful degree of credit protection.

Additional Requirements for Recognized Credit Derivatives

The Agencies are proposing that credit derivatives, whether in the form of credit default swaps or total return swaps, recognized for A–IRB risk-based capital purposes meet additional criteria. The credit events specified by the contracting parties would be required to include at a minimum: (i) Failure to pay amounts due under the terms of the underlying obligation; (ii) bankruptcy, insolvency, or inability of the obligor to pay its debt; and (iii) restructuring of the underlying obligation that involves forgiveness or postponement of principal, interest, or fees that results in a credit loss.

With regard to restructuring events, the Agencies note that the New Accord suggests that a banking organization may not need to include restructuring credit events when it has complete control over the decision of whether or not there will be a restructuring of the underlying obligation. This would occur, for example, where the hedged obligation requires unanimous consent of the creditors for a restructuring. The Agencies have concerns that this approach could have the incidental effect of dictating terms in underlying obligations in ways that over time could diverge from creditors' business needs. The Agencies also question whether such clauses actually eliminate restructuring risk on the underlying obligation, particularly as many credit derivatives hedge only a small portion of a banking organization's exposure to the underlying obligation.

The Agencies invite comment on this issue, as well as consideration of an alternative approach whereby the notional amount of a credit derivative that does not include restructuring as a credit event would be discounted. Comment is sought on the appropriate level of discount and whether the level of discount should vary on the basis of, for example, whether the underlying obligor has publicly outstanding rated debt or whether the underlying obligor is an entity whose obligations have a relatively high likelihood of restructuring relative to default (for example, a sovereign or PSE). Another alternative that commenters may wish to discuss is elimination of the restructuring requirement for credit derivatives with a maturity that is considerably longer—for example, two years—than that of the hedged obligation.

Consistent with the New Accord, the Agencies are proposing not to recognize credit protection from total return swaps where the hedging banking organization records net payments received on the swap as net income, but does not record offsetting deterioration in the value of the hedged obligation either through reduction in fair value or by an addition to reserves. The Agencies are considering imposing similar non-recognition on credit default swaps where mark-to-market gains in value are recognized in income and, thus, in Tier 1 capital, but no offsetting deterioration in the hedged obligation is recorded. (This situation generally would not arise where both the hedged obligation and the credit default swap are recorded in the banking book because under GAAP increases in the swap's value are recorded in the Other Comprehensive Income account, which is not included in regulatory capital.)

Comment is sought on this matter, as well as on the possible alternative treatment of recognizing the hedge in these two cases for regulatory capital purposes but requiring that mark-to-market gains on the credit derivative that have been taken into income be deducted from Tier 1 capital.

Mismatches in Credit Derivatives Between Reference and Underlying Obligations

The Agencies are proposing to recognize credit derivative hedges for

A–IRB capital purposes only where the reference obligation on which the protection is based is the same as the underlying obligation except where: (1) the reference obligation ranks *pari passu* with or is more junior than the underlying obligation, and (2) the underlying obligation and reference obligation share the same obligor and legally enforceable cross-default or cross-acceleration clauses are in place.

Treatment of Maturity Mismatch

The Agencies are proposing to recognize on a discounted basis guarantees and credit derivatives that have a shorter maturity than the hedged obligation. A guarantee or credit derivative with less than one-year remaining maturity that does not have a matching maturity to the underlying obligation, however, would not be recognized. The formula for discounting the amount of a maturity-mismatched hedge that is recognized is proposed as follows:

$Pa = P * t/T$

Where:

Pa denotes the value of the credit protection adjusted for maturity mismatch;

P denotes the amount of the credit protection;

t denotes the lesser of T and the remaining maturity of the hedge arrangement, expressed in years; and

T denotes the lesser of five and the remaining maturity of the underlying obligation, expressed in years.

The Agencies have concerns that the proposed formulation does not appropriately reflect distinctions between bullet and amortizing underlying obligations. Comment is sought on the best way of making such a distinction, as well as more generally on alternative methods for dealing with the reduced credit risk coverage that results from a maturity mismatch.

Treatment of Counterparty Risk for Credit Derivative Contracts

The Agencies are proposing that the EAD for derivative contracts included in either the banking book or trading book be determined in accordance with the rules for calculating the credit equivalent amount for such contracts set forth under the general risk-based capital rules. The Agencies are proposing to include in the types of derivative contracts covered under these rules credit derivative contracts recorded in the trading book. Accordingly, where a banking organization buys or sells a credit derivative through its trading book, a counterparty credit risk capital charge would be imposed based on the replacement cost plus the following add-on factors for PFE:

Total return or credit default swap	Protection buyer (percent)	Protection seller (percent)
Qualifying Reference Obligation*	5	**5
Non-Qualifying Reference Obligation*	10	**10

*The definition of qualifying would be the same as for the ‘‘qualifying’’ category for the treatment of specific risk for covered debt positions under the market risk capital rules.

**The protection seller of a credit default swap would only be subject to the add-on factor where the contract is subject to close-out upon the insolvency of the protection buyer while the underlying obligor is still solvent.

The Agencies also are considering applying a counterparty credit risk charge on all credit derivatives that are marked-to-market, including those recorded in the banking book. Such a treatment would promote consistency with other OTC derivatives, which are assessed the same counterparty credit risk charge regardless of where they are booked.

Further, the Agencies note that, if credit derivatives booked in the banking book are not assessed a counterparty credit risk charge, banking organizations would be required to exclude these derivatives from the net current exposure of their other derivative exposures to a counterparty for purposes of determining regulatory capital requirements. On balance, the Agencies believe a better approach would be to align the net derivative exposure used for capital purposes with that used for internal risk management purposes to manage counterparty risk exposure and collateralization thereof. This approach would suggest imposing a counterparty risk charge on all credit derivative exposures that are marked to market, regardless of where they are booked.

The Agencies are seeking industry views on the PFE add-ons proposed above and their applicability. Comment is also sought on whether different add-ons should apply for different remaining maturity buckets for credit derivatives and, if so, views on the appropriate percentage amounts for the add-ons in each bucket.

Equity Exposures

Banking organizations using the A–IRB approach for any credit exposure would be required to use an internal models market-based approach to calculate regulatory capital charges for equity exposures. Minimum quantitative and qualitative requirements for using an internal model would have to be met on an ongoing basis. An advanced approach banking organization that is transitioning into an internal models approach to equity exposures or that fails to demonstrate compliance with the minimum operational requirements for using an internal models approach to equity exposures would be required to develop a plan for compliance, obtain approval of the plan from its primary Federal supervisor, and implement the plan in a timely fashion. In addition, a banking organization's primary Federal supervisor would have the authority to impose additional operational requirements on a case-by-case basis. Until it is fully compliant with all applicable requirements, the banking organization would apply a minimum 300 percent risk weight to all publicly traded equity investments (that is, equity investments that are traded on a nationally recognized securities exchange) and a minimum 400 percent risk weight to all other equity investments.

Positions Covered

All equity exposures held in the banking book, along with any equity exposures in the trading book that are not currently subject to a market risk capital charge, would be subject to the A-IRB approach for equity exposures. In general, equity exposures are distinguished from other types of exposures based on the economic substance of the exposure. Equity exposures would include both direct and indirect ownership interests, whether voting or non-voting, in the assets or income of a commercial enterprise or financial institution that are not consolidated or deducted for regulatory capital purposes. Holdings in funds containing both equity investments and non-equity investments would be treated either as a single investment based on the majority of the fund's holdings or, where possible, as separate and distinct investments in the fund's component holdings based on a ‘‘look-through approach’’ (that is, based on the individual component holdings).

An instrument generally would be considered to be an equity exposure if it (1) would qualify as Tier 1 capital under the general risk-based capital rules if issued by a banking organization; (2) is irredeemable in the sense that the return of invested funds can be achieved only by the sale of the investment or sale of the rights to the investment or in the event of the liquidation of the issuer; (3) conveys a residual claim on the assets or income of the issuer; and (4) does not embody an obligation on the part of the issuer.

An instrument that embodies an obligation on the part of the issuer would be considered an equity exposure if the instrument meets any of the following conditions: (1) The issuer may defer indefinitely the settlement of the obligation; (2) the obligation requires, or permits at the issuer's discretion, settlement by the issuance of a fixed number of the issuer's equity interests; (3) the obligation requires, or permits at the issuer's discretion, settlement by the issuance of a variable number of the issuer's equity interests, and all things being equal, any change in the value of the obligation is attributable to, comparable to, and in the same direction as, the change in value of a fixed number of the issuer's equity shares; or (4) the holder has the option to require that the obligation be settled by issuance of the issuer's equity interests, unless the banking organization's primary Federal supervisor has opined in writing that the instrument should be treated as a debt position.

Debt obligations and other securities, derivatives, or other instruments structured with the intent of conveying the economic substance of equity ownership would be considered equity exposures for purposes of the A-IRB capital requirements. For example, options and warrants on equities and short positions in equity securities would be characterized as equity exposures. If a debt instrument is convertible into equity at the option of the holder, it would be deemed equity upon conversion. If such debt is convertible at the option of the issuer or automatically by the terms of the instrument, it would be deemed equity from inception. In addition, instruments with a return directly linked to equities would be characterized as equity exposures under most circumstances. A banking organization's primary Federal supervisor would have the discretion to allow a debt characterization of such an equity-linked instrument, however, if the instrument is directly hedged by an equity holding such that the net position does not involve material equity risk to the holder. Equity instruments that are structured with the intent of conveying the economic substance of debt holdings, or securitization exposures would not be considered equity exposures. For example, some issuances of term preferred stock may be more appropriately characterized as debt.

In all cases, the banking organization's primary Federal supervisor would have the discretion to recharacterize debt holdings as equity exposures or equity holdings as debt or securitization exposures for regulatory capital purposes.

The Agencies encourage comment on whether the definition of an equity exposure is sufficiently clear to allow banking organizations to make an appropriate determination as to the characterization of their assets.

Materiality

As noted above, a banking organization that is required or elects to use the A–IRB approach for any credit portfolio would also generally be required to use the A–IRB approach for its equity exposures. However, if the aggregate equity holdings of a banking organization are not material in amount, the organization would not be required to use the A–IRB approach to equity exposures. For this purpose, a banking organization's equity exposures generally would be considered material if their aggregate carrying value, including holdings subject to exclusions and transitional provisions (as described below), exceeds 10 percent of the organization's Tier 1 and Tier 2 capital on average during the prior calendar year. To address concentration concerns, however, the materiality threshold would be lowered to 5 percent of the banking organization's Tier 1 and Tier 2 capital if the organization's equity portfolio consists of less than ten individual holdings. Banking organizations would risk weight at 100 percent equity exposures exempted from the A–IRB equity treatment under a materiality threshold.

Comment is sought on whether the materiality thresholds set forth above are appropriate. Exclusions from the A–IRB Equity Capital Charge

Zero and Low Risk Weight Investments

The New Accord provides that national supervisors may exclude from the A–IRB capital charge those equity exposures to entities whose debt obligations qualify for a zero risk weight under the New Accord's standardized approach for credit risk. Entities whose debt obligations qualify for a zero risk weight generally include (i) sovereigns rated AAA to AA–; (ii) the BIS; (iii) the IMF; (iv) the European Central Bank; (v) the European Community; and (vi) high-quality multilateral development banks (MDBs) with strong shareholder support.[27] The Agencies intend to exclude from the A-IRB equity capital charge equity investments in these entities. Instead, these investments would be risk weighted at zero percent under the A-IRB approach.

In addition, the Agencies are proposing to exempt from the A-IRB equity capital charge investments in non-central government public-sector entities (PSEs) that are not traded publicly and generally are held as a condition of membership. Examples of such holdings include stock of a Federal Home Loan Bank or a Federal Reserve Bank. These investments would be risk-weighted as they would be under the general risk-based capital rules—20 percent or zero percent, respectively, in the examples.

Comment is sought on whether other types of equity investments in PSEs should be exempted from the A–IRB capital charge on equity exposures, and if so, the appropriate criteria for determining which PSEs should be exempted.

Legislated Program Equity Exposures

Under the New Accord, national supervisors may exclude from the A–IRB capital charge on equity exposures certain equity exposures made under legislated programs that involve government oversight and restrictions on the types or amounts of investments that may be made (legislated program equity exposures). Under the New Accord, a banking organization would be able to exclude from the A–IRB capital charge on equity exposures legislated program equity exposures in an amount up to 10 percent of the banking organization's Tier 1 plus Tier 2 capital.

The Agencies propose that equity investments by a banking organization in a small business investment company (SBIC) under section 302(b) of the Small Business Investment Act of 1958 would be legislated program equity exposures eligible for the exclusion from the A–IRB equity capital charge in an amount up to 10 percent of the banking organization's Tier 1 plus Tier 2 capital. A banking organization would be required to risk weight at 100 percent any amounts of legislated program equity exposures that qualify for this exclusion from the A–IRB equity capital charge.

The Agencies seek comment on what conditions might be appropriate for this partial exclusion from the A–IRB equity capital charge. Such conditions could include limitations on the size and types of

[27] These are, at present, the World Bank group comprised of the International Bank for Reconstruction and Development and the International Finance Corporation, the Asian Development Bank, the African Development Bank, the European Bank for Reconstruction and Development, the Inter-American Development Bank, the European Investment Bank, the Islamic Development Bank, the Nordic Investment Bank, the Caribbean Development Bank, and the Council of Europe Development Bank.

businesses in which the banking organization invests, geographical limitations, or limitations on the size of individual investments.

U.S. banking organizations also make investments in community development corporations (CDCs) or community and economic development entities (CEDEs) that promote the public welfare. These investments receive favorable tax treatment and investment subsidies that make their risk and return characteristics markedly different (and more favorable to investors) than equity investments in general. Recognizing this more favorable risk-return structure and the importance of these investments to promoting important public welfare goals, the Agencies are proposing the exclusion of all such investments from the A–IRB equity capital charge. Unlike the exclusion for SBIC exposures, the exclusion of CDC and CEDE investments would not be subject to a percentage of capital limit. All CDC and CEDE equity exposures would receive a 100 percent risk weight.

The Agencies seek comment on whether any conditions relating to the exclusion of CDC/CEDE investments from the A-IRB equity capital charge would be appropriate. These conditions could serve to limit the exclusion to investments in such entities that meet specific public welfare goals or to limit the amount of such investments that would qualify for the exclusion from the A–IRB equity capital charge. The Agencies also seek comment on whether any other classes of legislated program equity exposures should be excluded from the A–IRB equity capital charge.

Grandfathered Investments

Equity exposures held as of the date of adoption of the final A–IRB capital rule governing equity exposures would be exempt from the A–IRB equity capital charge for a period of ten years from that date. A banking organization would be required to risk weight these holdings during the ten-year period at 100 percent. The investments that would be considered grandfathered would be equal to the number of shares held as of the date of the final rule, plus any shares that the holder acquires directly as a result of owning those shares, provided that any additional shares do not increase the holder's proportional ownership share in the company.

For example, if a banking organization owned 100 shares of a company on the date of adoption of the final rule, and the issuer thereafter declared a pro rata stock dividend of 5 percent, the entire post-dividend holdings of 105 shares would be exempt from the A–IRB equity capital charge for a period of ten years from the date of the adoption of the final rule. However, if additional shares are acquired such that the holder's proportional share of ownership increases, the additional shares would not be grandfathered. Thus, if a banking organization owned 100 shares of a company on the date of adoption of the final rule and subsequently acquired an additional 50 shares, the original 100 shares would be exempt from the A–IRB equity capital charge for the ten-year period from the date of adoption of the final rule, but the additional 50 shares would be immediately subject to the A–IRB equity capital charge.

Description of Quantitative Principles

The primary focus of the A–IRB approach to equity exposures is to assess capital based on an internal estimate of loss under extreme market conditions on an institution's portfolio of equity holdings or, in simpler forms, its individual equity investments. The methodology or methodologies used to compute the banking organization's estimated loss should be those used by the institution for internal risk management purposes. The model should be fully integrated into the banking organization's risk management infrastructure.

A banking organization's use of internal models would be subject to supervisory approval and ongoing review by the institution's primary Federal supervisor. Given the unique nature of equity portfolios and differences in modeling techniques, the supervisory model review process would be, in many respects, institution-specific. The sophistication and nature of the modeling technique used for a particular type of equity exposure should correspond to the banking organization's exposure, concentration in individual equity issues of that type, and the particular risk of the holding (including any optionality). Institutions would have to use an internal model that is appropriate for the risk characteristics and complexity of their equity portfolios. The model would have to be able to capture adequately all of the material risks embodied in equity returns, including both general market risk and idiosyncratic (that is, specific) risk of the institution's equity portfolio.

In their evaluations of institutions' internal models, the Agencies would consider, among other factors, (a) the nature of equity holdings, including the number and types of equities (for example, public, private, long, short); (b) the risk characteristics and makeup of institutions' equity portfolio holdings, including the extent to which publicly available price information is obtainable on the exposures; and (c) the level and degree of concentration. Institutions with equity portfolios containing holdings with values that are highly nonlinear in nature (for example, equity derivatives or convertibles) would have to employ an internal model designed to appropriately capture the risks associated with these instruments.

The Agencies recognize that the type and sophistication of internal modeling systems will vary across institutions due to differences in the nature and complexity of business lines in general and equity exposures in particular. Although the Agencies intend to use a VaR methodology as a benchmark for the internal model approach, the Agencies recognize that some institutions employ models for internal risk management and capital allocation purposes that, given the nature of their equity holdings, can be more risk-sensitive than some VaR models. For example, some institutions employ rigorous historical scenario analysis and other techniques in assessing the risk of their equity portfolios. It is not the Agencies' intention to dictate the form or operational details of banking organizations' risk measurement and management practices for their equity exposures. Accordingly, the Agencies do not expect to prescribe any particular type of model for computing A-IRB capital charges for equity exposures.

For purposes of evaluating the A–IRB equity capital charges produced by a banking organization's selected methodology, the Agencies would expect to use as a benchmark a VaR methodology using a 99.0 percent (one-tailed) confidence level of estimated maximum loss over a quarterly time horizon using a long-term sample period. Moreover, A–IRB equity capital charges would have to produce risk weights for equity exposures that are at least equal to a 200 percent risk weight for publicly traded equity exposures, and a 300 percent risk weight for all other equity exposures.

VaR-based internal models must use a historical observation period that includes a sufficient amount of data points to ensure statistically reliable and robust loss estimates relevant to the long-term risk profile of the institution's specific holdings. The data used to represent return distributions should reflect the longest sample period for which data are available and should meaningfully represent the risk profile of the banking organization's specific equity holdings. The data sample should be long-term in nature and, at a minimum, should encompass at least one complete equity market cycle relevant to the institution's holdings, including both increases and decreases in relevant equity values over a long-term data period. The data used should be sufficient to provide conservative, statistically reliable, and robust loss estimates that are not based purely on subjective or judgmental considerations.

The parameters and assumptions used in a VaR model must be subject to a rigorous and comprehensive regime of stress-testing. Banking organizations utilizing VaR models would be required to subject their internal model and estimation procedures, including volatility computations, to either hypothetical or historical scenarios that reflect worst-case losses given underlying positions in both public and private equities. At a minimum, banking organizations that use a VaR model would be required to employ stress tests to provide information about the effect of tail events beyond the level of confidence assumed in the internal models approach.

Banking organizations using non-VaR internal models that are based on stress tests or scenario analyses would have to estimate losses under worst-case modeled scenarios. These scenarios would have to reflect the composition of the organization's equity portfolio and should produce capital charges at least as large as those that would be required to be held against a representative market index under a VaR approach. For example, for a portfolio consisting primarily of publicly held equity securities that are actively traded, capital charges produced using historical scenario analyses would have to be greater than or equal to capital charges produced by a baseline VaR approach for a major index that is representative of the institution's holdings.

The measure of an equity exposure on which A–IRB capital requirements would be based would be the value of the equity presented in a banking organization's financial statements. For investments held at fair value, the exposure amount would be equal to the fair value presented in the balance sheet. For investments held at the lower of cost or market value, the exposure amount would be equal to the cost or market value presented in the balance sheet.

The loss estimate derived from the internal model would constitute the A–IRB capital charge to be assessed against the equity exposure. The A–IRB equity capital charge would be incorporated into an institution's risk-based capital ratio through the calculation of risk-weighted equivalent assets. To convert the A–IRB equity capital charge into risk-weighted equivalent assets, a banking organization would multiply the capital charge by a factor of 12.5.

Consistent with the general risk-based capital rules, 45 percent of the positive change in value held in the tax-adjusted separate component of equity—that is, 45 percent of revaluation gains on available-for-sale (AFS) equity securities—would be includable in Tier 2 capital under the A–IRB framework.

Comment is specifically sought on whether the measure of an equity exposure under AFS accounting continues to be appropriate or whether a different rule for the inclusion of revaluation gains should be proposed.

C. Supervisory Assessment of A–IRB Framework

A banking organization would have to satisfy all the A–IRB infrastructure requirements and supervisory standards before it would be able to use the A–IRB approach for calculating capital requirements for credit risk. This section describes key elements of the framework on which the Agencies propose to base the A–IRB qualifying requirements for U.S. banking organizations. The Agencies intend to provide more detailed implementation guidance in regard to these issues for wholesale and retail exposures, as well as for equity and securitization exposures. As noted earlier, draft guidance for corporate exposures that identifies associated supervisory standards was published elsewhere in today's **Federal Register**.

Overview of Supervisory Framework

Many of the supervisory standards are focused on requirements for a banking organization's internal risk rating system. Emphasis is placed on a banking organization's ability to rank order and quantify risk in a consistent, reliable and valid manner. In sum, a banking organization's internal risk rating system would have to provide for a meaningful differentiation of the riskiness of borrowers, as well as the risks inherent in individual transactions. To ensure the reliability of these estimates, internal risk rating systems would need to be subject to review by independent control units. Data sources and estimation methods used by banking organizations would need to be sufficiently robust to support the production of consistent quantitative assessments of risk over time. Finally, to ensure that ratings are not derived solely for regulatory capital purposes, internal risk rating systems and quantification methods would need to form an integral part of the management of the institution, as outlined below.

It is important to emphasize that the Agencies believe that meeting the A–IRB infrastructure requirements and supervisory standards will require significant efforts by banking organizations. The A–IRB supervisory standards will effectively ''raise the bar'' in regard to sound credit risk management practices.

Rating System Design

The design of an internal risk rating system is key to its effectiveness. By definition, a rating system comprises all of the processes that support the assessment of credit risk, the assignment of internal risk ratings, and the quantification of default and loss estimates. Banking organizations would be able to rely on one or more systems for assessing their credit risk exposures. When this is the case, the banking organization would have to demonstrate that each system used for A–IRB capital purposes complies with the supervisory standards.

The Agencies believe that banking organizations' internal rating systems should accurately and consistently differentiate degrees of risk. For wholesale exposures, banking organizations would need to have a two-dimensional rating system that separately assesses the risk of borrower default, as well as transaction-specific factors that focus on the amount that would likely be collected in the event of default. Such factors may include whether an exposure is collateralized, its seniority, and the product type. In contrast to the individual evaluation required for wholesale exposures, retail exposures would be assessed on a pool basis. Banking organizations would need to group their retail exposures into portfolio segments based on the risk characteristics that they consider relevant—for example borrower characteristics such as credit scores or transaction characteristics such as product or collateral type. Delinquent or defaulted exposures would need to be separated from those that are current.

Banking organizations would be required to define clearly their wholesale rating categories and retail portfolio segments. The clarity and transparency of the ratings criteria are critical to ensuring that ratings are assigned in a consistent and reliable manner. The Agencies believe it is important for banking organizations to document the operating procedures for their internal risk rating system in writing. For example, the documentation should describe which parties within the organization would have the authority to approve exceptions. Further, the documentation would have to clearly specify the frequency of review, as well as describe the oversight to be provided by management of the ratings process.

Banking organizations using the A–IRB approach would need to be able to generate sound measurements of the key risk inputs to the A–IRB capital formulas. Banking organizations would be able to rely on data based either on internal experience or generated by an external source, as long as the banking organization can demonstrate the relevance of external data to its own experience.

In assigning a rating to an obligor, a banking organization must assess the risk of default, taking into account possible adverse events that might increase the obligor's likelihood of default. The A–IRB supervisory standards in the supervisory guidance provide banking organizations with a degree of flexibility in determining precisely how to reflect adverse events in obligor ratings. However, banking organizations are required to clearly articulate the approach chosen, and to articulate the implications for capital planning and for capital adequacy during times of systematic economic stress. The Agencies recognize that banking organizations' internal risk rating systems may include a range of statistical models or other methods to assign borrower or facility ratings or to estimate key inputs. The burden of proof would remain on the banking organization as to whether a specific model or procedure satisfies the supervisory standards.

Risk Rating System Operations

The risk rating system would have to form an integral part of the loan approval process wherein ratings are assigned to all borrowers, guarantors, or facilities depending upon whether the extension of credit is wholesale or retail in nature. Any deviations from policies that govern the assignment of ratings must be clearly documented and monitored.

Data maintenance is another key aspect of risk rating system operations. Banking organizations would be expected to collect and store data on key borrower and facility characteristics. The data would have to be sufficiently detailed to allow for future reconsideration of the way in which obligors and facilities have been allocated to grades. Furthermore, banking organizations would have to collect, retain, and disclose data on aspects of their internal ratings as described under the disclosure section of this proposal.

Banking organizations would be required to have in place sound stress testing processes for use in the assessment of capital adequacy. Stress testing would have to involve identifying possible events or future changes in economic conditions that could have unfavorable effects on a banking organization's credit exposures. Specifically, institutions would need to assess the effect of certain specific conditions on their A–IRB regulatory capital requirements. The choice of test to be employed would remain with the individual banking organization provided the method selected is meaningful and reasonably conservative.

Corporate Governance and Oversight

The Agencies view the involvement of the board of directors and management as critical to the successful implementation of the A–IRB approach. The board of directors and management would be responsible for maintaining effective internal controls over the banking organization's information systems and processes for assessing adequacy of regulatory capital and determining regulatory capital charges consistent with this ANPR. All significant aspects of the rating and estimation processes would have to be approved by the banking organization's board of directors or a designated committee thereof and senior management. These parties would need to be fully aware of whether the system complies with the supervisory standards, makes use of the necessary data, and produces reliable quantitative estimates. Ongoing management reports would have to accurately capture the performance of the rating system.

Oversight would also need to involve independent credit risk control units responsible for ensuring the performance of the rating system, the accuracy of the ratings and parameter estimates, and overall compliance with supervisory standards and capital regulations. The Agencies believe it is critical that such units remain functionally independent from the personnel and management responsible for originating credit exposures. Among other responsibilities, the control units should be charged with testing and monitoring the appropriateness of the rating scale, verifying the consistent use of ratings for a given exposure type across the organization, and reviewing and documenting any changes to be made to the system.

Use of Internal Ratings

To qualify to use the A–IRB framework, a banking organization's rating systems would have to form an integral part of its day-to-day credit risk management process. The Agencies expect that banking organizations would rely on their internal risk rating systems when making decisions about whether to extend credit as well as in their ongoing monitoring of credit exposures. For example, ratings information would have to be incorporated into other key processes, such as reserving determinations and when allocating economic capital internally.

Risk Quantification

Ratings quantification is the process of assigning values to the key risk components of the A–IRB approach: PD, LGD, EAD and M. With the exception of M, the risk components are unobservable and must be estimated. The estimates would have to be consistent with sound practice and supervisory standards. Banking organizations' rating system review and internal audit functions would need to serve as control mechanisms that ensure the process of rating assignments and quantification are functioning according to policy and that non-compliance or weaknesses are identified.

Validation of Internal Estimates

An equally important element would be a robust system for validating the accuracy and consistency of a banking organization's rating system, as well as the estimation of risk components. The standards in the supervisory guidance require that banking organizations use a broad range of validation tools, including evaluation of developmental evidence, ongoing monitoring of rating and quantification processes, benchmarking against alternative approaches, and comparison of outcomes with estimates. Details of the validation process would have to be consistent with the operation of the banking organization's rating system and data would have to be maintained and updated to support oversight and validation work. Banking organizations would have to have well-articulated standards for situations where deviations of realized values from expectations become significant enough to call the validity of the estimates into question. Rating systems with appropriate data and oversight feedback mechanisms should create an environment that promotes integrity and improvements in the rating system over time.

U.S. Supervisory Review

The primary Federal supervisor would be responsible for evaluating an institution's initial and ongoing compliance with the infrastructure requirements and supervisory standards for approval to use the A-IRB approach for regulatory capital purposes. As noted, the Agencies will be developing and issuing specific implementation guidance describing the supervisory standards for wholesale, retail, equity and securitization exposures. The Agencies will issue the draft implementation guidance for each portfolio for public comment to ensure that there is an opportunity for banking organizations and others to provide feedback on the Agencies' expectations in regard to A–IRB systems.

The Agencies seek comment on the extent to which an appropriate balance has been struck between flexibility and comparability for the A-IRB requirements. If this balance is not appropriate, what are the specific areas of imbalance, and what is the potential impact of the identified imbalance? Are there alternatives that would provide greater flexibility, while meeting the overall objectives of producing accurate and consistent ratings?

The Agencies also seek comment on the supervisory standards contained in the draft guidance on internal ratings-based systems for corporate exposures. Do the standards cover all of the key elements of an A–IRB framework? Are there specific practices that appear to meet the objectives of accurate and consistent ratings but that would be ruled out by the supervisory standards related to controls and oversight? Are there particular elements from the corporate guidance that should be modified or reconsidered as the Agencies draft guidance for other types of credit?

In addition, the Agencies seek comment on the extent to which these proposed requirements are consistent with the ongoing improvements banking organizations are making in credit-risk management processes.

IV. Securitization

A. General Framework

This section describes the calculation of A–IRB capital requirements for securitization exposures. A securitization exposure is any on- or off-balance-sheet position created by aggregating and then tranching the risks of a pool of assets, commitments, or other instruments (underlying exposures) into multiple financial interests where, typically, the pooled risks are not shared *pro rata.* The pool may include one or more underlying exposures. Examples include all exposures arising from traditional and synthetic securitizations, as well as partial guarantee arrangements where credit losses are not divided proportionately among the parties (often referred to as tranched cover). Asset- and mortgage-backed securities (including those privately issued and those issued by GSEs such as Fannie Mae and Freddie Mac), credit enhancements, liquidity facilities, and credit derivatives that have the characteristics noted above would be considered securitization exposures.

With ongoing advances in financial engineering, the Agencies recognize that securitization exposures having similar risks can take different legal forms. For this reason, both the designation of positions as securitization exposures and the calculation of A–IRB capital requirements for securitization exposures would be guided by the economic substance of a given transaction, rather than by its legal form.

Operational Criteria

Banking organizations would have to satisfy certain operational criteria to be eligible to use the A–IRB approach to securitization exposures. Moreover, all banking organizations that use the A–IRB approach for the underlying exposures that have been securitized would have to apply the A–IRB treatment for securitization exposures. Minimum operational criteria would apply to traditional and synthetic securitizations. The Agencies propose to establish supervisory criteria for determining when, for risk-based capital purposes, a banking organization may treat exposures that it has originated directly or indirectly as having been securitized and, hence, not subject to the same capital charge as if the banking organization continued to hold the assets. The Agencies anticipate these supervisory criteria will be substantially equivalent to the criteria contained in the New Accord (paragraphs 516–520). Broadly, these criteria are intended to ensure that securitization transactions transfer significant credit risk to third parties and, in the case of traditional securitizations, that each transaction qualifies as a true sale under applicable accounting standards.

The supervisory criteria also would describe the types of clean-up calls that may be incorporated within transactions qualifying for the A–IRB securitization treatment.[28] Specifically, any clean-up call would have to meet the following conditions: (a) Its exercise is at the discretion of the originating banking organization; (b) it does not serve as a credit enhancement; and (c) it is only exercisable when 10 percent or less of the original underlying portfolio or reference portfolio value remains. If a clean-up call does not meet all of these criteria, the originating banking organization would have to treat the underlying exposures as if they had not been securitized.

The Agencies seek comment on the proposed operational requirements for securitizations. Are the proposed criteria for risk transference and clean-up calls consistent with existing market practices?

Differences Between General A–IRB Approach and the A–IRB Approach for Securitization Exposures

In contrast to the proposed A–IRB framework for traditional loans and commitments, the A–IRB securitization framework does not rely on a banking organization's own internal assessments of the PD and LGD of a securitization exposure. For securitization exposures backed by pools of multiple assets, such assessments require implicit or explicit estimates of correlations among the losses on those assets. Such correlations are extremely difficult to estimate and validate in an objective manner and on a going-forward basis. For this reason, the A–IRB framework generally would not permit a banking organization to use its internal risk assessments of PD or LGD when such assessments depend, implicitly or explicitly, on estimates of correlation effects. The A–IRB treatment of securitization exposures would rely principally on two sources of information, when available: (i) An assessment of the securitization exposure's credit risk made by an external rating agency; and (ii) the A–IRB capital charge that would have been assessed against the underlying exposures had the exposures not been securitized (the pool's A–IRB capital charge), along with other information about the transaction.

B. Determining Capital Requirements

General Considerations

Because the information available to a banking organization about a securitization exposure often reflects the organization's role in a securitization transaction, the Agencies are proposing that the method of calculating the A–IRB capital requirement for a securitization exposure may depend on whether a banking organization is an originator or a third-party investor in the securitization transaction. In general, a banking organization would be considered an originator of a securitization if the organization directly or indirectly originated the underlying exposures or serves as the sponsor of an asset-backed commercial paper (ABCP) conduit or similar

[28] In general terms, a clean-up call is an option that permits an originating banking organization to call the securitization exposures (for example, asset- or mortgage-backed securities) before all of the underlying exposures have been repaid.

program.[29] If a banking organization is not deemed an originator of a securitization transaction, then it would be considered an investor in the securitization.

There are several methods for determining the A–IRB capital requirement for a securitization exposure: the Ratings-Based Approach (RBA), the Alternative RBA, the Supervisory Formula Approach (SFA), the Look-Through Approach, deduction from Tier 1 capital, and deduction from total capital. The following table summarizes conditions under which a banking organization would apply each of these methods. In this table, KIRB denotes the ratio of (a) the pool's A–IRB capital charge to (b) the notional or loan equivalent amount of underlying exposures in the pool.

Steps for Determining A–IRB Capital Requirements for Securitization Exposures

For an investing banking organization:
1. Deduct from total capital any credit-enhancing interest-only strips
2. When an external or inferred rating exists, apply the RBA
3. When an external or inferred rating does not exist, do the following:
a. Subject to supervisory review and approval, if the investing banking organization can determine KIRB, then calculate required capital as would an originating banking organization using the steps described in 2.a. below
b. Otherwise, deduct the exposure from total capital

For an originating banking organization:*
1. Deduct from Tier 1 capital any increase in capital resulting from the securitization transaction and deduct from total capital any credit-enhancing interest-only strips (net of deductions from Tier 1 capital due to increases in capital)
2. When an A–IRB approach exists for the underlying exposures do the following:
a. If KIRB can be determined:
i. For a securitization exposure (or portion thereof) that is at or below KIRB, deduct the exposure from total capital
ii. For a securitization exposure (or portion thereof) that is above KIRB:
1. Apply the RBA whenever an external or inferred rating is available
2. Otherwise, apply the SFA
b. If KIRB cannot be determined:
i. Apply the Look-Through Approach if the exposure is an eligible liquidity facility, subject to supervisory approval
ii. Otherwise, deduct the exposure from total capital
3. When an A–IRB approach does not exist for the underlying exposures do the following:
a. Apply the Look-Through Approach if the exposure is an eligible liquidity facility, subject to supervisory approval
b. Otherwise, apply the Alternative RBA

Deductions of Gain-on-Sale or Other Accounting Elements That Result in Increases in Equity Capital

Any increase in equity capital resulting from a securitization transaction (for example, a gain resulting from FAS 140 accounting treatment of the sale of assets) would be deducted from Tier 1 capital. Such deductions are intended to offset any gain on sale or other accounting treatments (''gain on sale'') that result in an increase in an originating banking organization's shareholders' equity and Tier 1 capital. Over time, as banking organizations, from an accounting perspective, realize the increase in equity that was booked at origination of a securitization transaction through actual receipt of cash flows, the amount of the required deduction would be reduced accordingly.

Banking organizations would have to deduct from total capital any on-balance-sheet credit-enhancing interest-only strips (net of any increase in the shareholders' equity deducted from Tier 1 capital as described in the previous paragraph).[30] Credit-enhancing interest-only strips are defined in the general risk-based capital rules and include items, such as excess spread, that represent subordinated cash flows of future margin income.

Maximum Capital Requirement

Where an A–IRB approach exists for the underlying exposures, an originating banking organization's total A–IRB capital charge for exposures associated with a given securitization transaction would be subject to a maximum or ceiling. This maximum A–IRB capital charge would equal the pool's A–IRB capital charge plus any required deductions, as described in the preceding paragraphs. The aim of this treatment is to ensure that an institution's effective A–IRB capital charge generally would not be greater after securitization than before, while also addressing the Agencies' safety and soundness concerns with respect to credit-enhancing interest-only strips and other capitalized assets.[31]

The proposed maximum A–IRB capital requirement effectively would reverse one aspect of the general risk-based capital rules for securitization exposures referred to as residual interests. Under the general risk-based capital rules, banking organizations are required to hold a dollar in capital for every dollar in residual interest, regardless of the capital requirement on the underlying exposures. One of the reasons the Agencies adopted the ''dollar-for-dollar'' capital treatment for residual interests is that in many instances the relative size of the exposure retained by the originating banking organization reveals additional market information about the quality of the underlying exposures and deal structure that may not have been captured in the capital requirement on the underlying exposures, had those exposures remained on the banking organization's balance sheet. The Agencies will continue to review the proposal for safety and soundness considerations and may consider retaining the current dollar-for-dollar capital treatment for residual interests, especially in those instances where an originator retains first loss and other deeply subordinated interests in amounts that significantly exceed the pool's A–IRB capital charge plus required deductions.

Comments are invited on the circumstances under which the retention of the treatment in the general risk-based capital rules for residual interests for banking organizations using the A–IRB approach to securitization would be appropriate.

Should the Agencies require originators to hold dollar-for-dollar capital against all retained securitization exposures, even if this treatment would result in an aggregate amount of capital required of the originator that exceeded the pool's A–IRB capital charge plus any applicable deductions? Please provide the underlying rationale.

Investors

Third-party investors generally do not have access to detailed, ongoing information about the credit quality of the underlying exposures in a securitization. In such cases, investors often rely upon credit assessments made by external rating agencies. For a securitization exposure held by an investing banking organization, and

[29] A banking organization is generally considered a sponsor of an ABCP conduit or similar program if, in fact or in substance, it manages or advises the conduit program, places securities into the market for the program, or provides liquidity support or credit enhancements to the program.

* In addition to the capital treatments delineated, an originating banking organization's total A–IRB capital charge with regard to any single securitization transaction is subject to a maximum or ceiling, as described later in this section.

[30] Deductions other than of increases in equity capital are to be taken 50 percent from Tier 1 capital and 50 percent from Tier 2 capital.

[31] The maximum capital, requirement also applies to investing banking organizations that receive approval to use the SFA.

where an A–IRB treatment for the underlying exposures exists, the institution would use the Ratings-Based Approach (RBA) described below if the securitization exposure is externally rated or if an inferred rating is available (as defined in the RBA discussion below). When neither an external rating nor an inferred rating is available, an investing banking organization would compute the A–IRB capital charge for the exposure using the methodology described below for originating institutions (subject to supervisory review and approval). Otherwise, the securitization exposure would be deducted 50 percent from Tier 1 capital and 50 percent from Tier 2 capital. The Agencies anticipate that investing banking organizations would apply the RBA in the vast majority of situations.

Originators

This section presumes that an A–IRB approach exists for the underlying exposures. If no A–IRB treatment exists for the underlying exposures, then an originating banking organization (originator) would use the Alternative RBA discussed below.

In contrast to third-party investors, banking organizations that originate securitizations are presumed to have much greater access to information about the current credit quality of the underlying exposures. In general, when an originator retains a securitization exposure, the A–IRB securitization framework would require the institution to calculate, on an ongoing basis, the underlying exposure pool's A–IRB capital requirement had the underlying exposures not been securitized (the pool's A–IRB capital charge), which would be based on the notional dollar amount of underlying exposures (the size of the pool). The pool's A–IRB capital charge would be calculated using the top-down or bottom-up method applicable to the type(s) of underlying exposure(s).[32] As noted above, the pool's A–IRB capital charge divided by the size of the pool is denoted KIRB.

An originator also would be expected to know: (a) Its retained securitization exposure's nominal size relative to the size of the pool (the exposure's ''thickness,'' denoted T); and (b) the notional amount of all more junior securitization exposures relative to the size of the pool (the exposure's ''credit enhancement level,'' denoted L). The retained securitization exposure's A–IRB capital requirement depends on the relationship between KIRB, T, and L. If an originator cannot determine KIRB, any retained securitization exposure would be deducted from capital. For eligible liquidity facilities (defined below in the Look Through Approach) provided to ABCP programs where a banking organization lacks the information necessary to calculate KIRB, the Look-Through Approach described below would be applied on a temporary basis and subject to supervisory approval.

Positions Below KIRB

An originating banking organization would deduct from capital any retained securitization exposure (or part thereof) that absorbs losses at or below the level of KIRB (that is, an exposure for which L+T ≤ KIRB).[33] This means that an originating banking organization would be given no risk-based capital relief unless it sheds at least some exposures below KIRB. Deduction from capital would be required regardless of the securitization exposure's external rating. This deduction treatment is in contrast to the A–IRB capital treatment for investors, who would be able to look to the external (or inferred) rating of a securitization exposure regardless of whether the exposure was below KIRB.

While this disparate treatment of originators and investors may be viewed as inconsistent with the principle of equal capital for equal risk, the Agencies believe it is appropriate in order to provide incentives for originating banks to shed highly subordinated securitization exposures. Such exposures contain the greatest credit risks. Moreover, these risks are difficult to evaluate, and risk quantifications tend to be highly sensitive to modeling assumptions that are difficult to validate objectively. The proposal to prevent an originator from using the RBA for securitization exposures below KIRB reflects, in part, a concern by the Agencies that the market discipline underpinning an external credit rating may be less effective when the rating applies to a retained, non-traded securitization exposure and is sought by an originator primarily for regulatory capital purposes.

The Agencies note that the specific securitization exposures retained by an originator that are subject to deduction treatment could change over time in response to variations in the credit quality of the underlying exposures. For example, if the pool's A–IRB capital charge were to increase after the inception of a securitization, additional portions of securitization exposures held by an originator may fall below KIRB and, thus, become subject to deduction. Therefore, when an originator retains a first-loss securitization exposure well in excess of KIRB, the originator's A–IRB capital requirement on the exposure could climb rapidly in the event of any marked deterioration of the underlying exposures. In general, an originator could minimize variability in future capital charges by minimizing the size of any retained first-loss securitization exposures.

Positions Above KIRB

When an originating banking organization retains a securitization exposure, or part thereof, that absorbs losses above the KIRB amount (that is, an exposure for which L + T > KIRB) and the banking organization has not already met the maximum capital requirement for securitization exposures described previously, the A–IRB capital requirement for the exposure would be calculated as follows. For securitization exposures having an external or inferred rating, the organization would calculate its A–IRB capital requirement using the RBA. However, if neither an external rating nor an inferred rating is available, an originator would be able to use the SFA, subject to supervisory review and approval. Otherwise, the organization would deduct the securitization exposure from total capital.

The Agencies seek comment on the proposed treatment of securitization exposures held by originators. In particular, the Agencies seek comment on whether originating banking organizations should be permitted to calculate A–IRB capital charges for securitizations exposures below the KIRB threshold based on an external or inferred rating, when available.

The Agencies seek comment on whether deduction should be required for all non-rated positions above KIRB. What are the advantages and disadvantages of the SFA approach versus the deduction approach?

Capital Calculation Approaches

The Ratings-Based Approach (RBA)

The RBA builds upon the widespread acceptance of external ratings by third-party investors as objective assessments of a securitization exposure's stand-alone credit risk. Certain minimum requirements would have to be satisfied in order for a banking organization to rely on an external credit rating for determining its A–IRB capital charge for a securitization exposure. To be

[32] For the purpose of determining the A–IRB capital requirement for a securitization exposure, the top-down method could be used regardless of the maturity of the underlying exposures, provided the other eligibility criteria for employing the top-down approach are satisfied.

[33] If an originator holds a securitization exposure that straddles KIRB, the exposure must be decomposed into two separate positions—one that is above KIRB and another that is at or below KIRB.

recognized for regulatory capital purposes, the external credit rating on a securitization exposure would have to be public and reflect the entire amount of credit risk exposure the banking organization has with regard to all payments owed to it under the exposure. In particular, if a banking organization is owed both principal and interest on a securitization exposure, the external rating on the exposure would have to fully reflect the credit risk associated with both payment streams. The Agencies propose to establish criteria to ensure the integrity of external ratings processes and banking organizations' use of these ratings under the RBA. These criteria are expected to be consistent with the proposed guidance provided in the New Accord (paragraph 525).

In certain circumstances, an ''inferred rating'' may be used for risk weighting a non-rated securitization exposure. Similar to the general risk-based capital rules, to qualify for use of an inferred rating, a non-rated securitization exposure would have to be senior in all respects to a subordinate rated position within the same securitization transaction. Further, the junior rated tranche would have to have an equivalent or longer remaining maturity than the non-rated exposure. Where these conditions are met, the non-rated exposure would be treated as if it had the same rating (an ''inferred rating'') as that of the junior rated tranche. External and inferred ratings would be treated equivalently.

Under the RBA, the capital charge per dollar of a securitization exposure would depend on: (i) The external rating (or inferred rating) of the exposure, (ii) whether the rating reflects a long-term or short-term assessment of the exposure's credit risk, and (iii) a measure of the effective number—or granularity—of the underlying exposures (N).[34] For a securitization exposure rated AA or AAA, the RBA capital charge also would depend on a measure of the exposure's relative seniority in the overall transaction (Q).[35]

Tables 1 and 2 below present the risk weights that would result from the RBA when a securitization exposure's external rating (or inferred rating) represents a long-term or short-term credit rating, respectively. In both tables, the risk weights in column 2 would apply to AA and AAA-rated securitization exposures when the effective number of exposures (N) is 100 or more, *and* the exposure's relative seniority (Q) is greater than or equal to 0.1 + 25/N. If the underlying exposures are retail exposures, N would be treated as infinite and the minimum qualifying value of Q would be 0.10. The Agencies anticipate that these risk weights would apply to AA and AAA-rated tranches of most retail securitizations. Column 4 would apply only to securitizations involving non-retail exposures for which N is less than 6, and column 3 would apply in all other situations.

Within each table, risk weights increase as external rating grades decline. Under the Base Case (column 3), for example, the risk weights range from 12 percent for AAA-rated exposures to 650 percent for exposures rated BB−. This pattern of risk weights is broadly consistent with analyses employing standard credit risk models and a range of assumptions regarding correlation effects and the types of exposures being securitized.[36] These analyses imply that, compared with a corporate bond having a given level of stand-alone credit risk (for example, as measured by its expected loss rate), a securitization tranche having the same level of stand-alone risk—but backed by a reasonably granular and diversified pool—will tend to exhibit more systematic risk.[37] This effect is most pronounced for below-investment grade tranches, and is the primary reason why the RBA risk weights increase rapidly as ratings deteriorate over this range—much more rapidly than for similarly rated corporate bonds. Similarly, for highly granular pools, the risk weights expected to apply to most AA and AAA-rated securitization exposures (7 percent and 10 percent, respectively) decline steeply relative to the risk weight applicable to A-rated exposures (20 percent, column 3)—again, more so than might be the case for similarly rated corporate bonds. The decline in risk weights as ratings improve over the investment grade range is less pronounced for the Base Case and for tranches backed by non-granular pools (column 4).

For securitization exposures rated below BB−, the proposed A–IRB treatment—deduction from capital—would be somewhat more conservative than suggested by credit risk modeling analyses. However, the Agencies believe this more conservative treatment would be appropriate in light of modeling uncertainties and the tendency for securitization exposures in this range, at least at the inception of the securitization transaction, to be non-traded positions retained by an originator because they cannot be sold at a reasonable price.

TABLE 1.—ABS RISK WEIGHTS BASED ON LONG-TERM EXTERNAL CREDIT ASSESSMENTS

External rating (illustrative)	Thick tranches backed by highly granular pools	Base case	Tranches backed by non-granular pools
AAA	7%	12%	20%
AA	10%	15%	25%
A	N/A	20%	35%
BBB+	N/A	50%	50%
BBB	N/A	75%	75%
BBB−	N/A	100%	100%
BB+	N/A	250%	250%
BB	N/A	425%	425%
BB−	N/A	650%	650%
Below BB−	N/A	Deduction	Deduction

[34] N is defined more formally in the discussion below of the Supervisory Formula Approach.

[35] Q is defined as the total size of all securitization exposures rated at least AA− that are pari passu or junior to the exposure of interest, measured relative to the size of the pool and expressed as a decimal. Thus, for a securitization transaction having an AAA-rated tranche in the amount of 70 percent of the pool, an AAA-rated tranche of 10 percent, a BBB-rated tranche of 10 percent, and a non-rated tranche of 10 percent, the values of Q associated with these positions would be 0.80, 0.10, 0, and 0, respectively.

[36] See Vladislav Peretyatkin and William Perraudin, ''Capital for Asset-Backed Securities,'' Bank of England, February 2003.

[37] See, for example, Michael Pykhtin and Ashish Dev, ''Credit Risk in Asset Securitizations: Analytical Model,'' *Risk* (May 2002) S16–S20.

TABLE 2.—ABS RISK WEIGHTS BASED ON SHORT-TERM EXTERNAL CREDIT ASSESSMENTS

External rating (illustrative)	Thick tranches backed by highly granular pools	Base case	Tranches backed by non-granular pools
A–1/P–1	7%	12%	20%
A–2/P–2	N/A	20%	35%
A–3/P–3	N/A	75%	75%
All other ratings	N/A	Deduction	Deduction

The Agencies seek comment on the proposed treatment of securitization exposures under the RBA. For rated securitization exposures, is it appropriate to differentiate risk weights based on tranche thickness and pool granularity?

For non-retail securitizations, will investors generally have sufficient information to calculate the effective number of underlying exposures (N).

What are views on the thresholds, based on N and Q, for determining when the different risk weights apply in the RBA?

Are there concerns regarding the reliability of external ratings and their use in determining regulatory capital? How might the Agencies address any such potential concerns?

Unlike the A–IRB framework for wholesale exposures, there is no maturity adjustment within the proposed RBA. Is this reasonable in light of the criteria to assign external ratings?

The Supervisory Formula Approach (SFA)

As noted above, when an explicit A–IRB approach exists for the underlying exposures, originating and investing banking organizations would be able to apply the SFA to non-rated exposures above the KIRB threshold, subject to supervisory approval and review. The Agencies anticipate that, in addition to its application to liquidity facilities and to other traditional and synthetic securitization exposures, the SFA would be used when calculating A–IRB capital requirements for tranched guarantees (for example, a loan for which a guarantor assumes a first-loss position that is less than the full amount of the loan).

Under the SFA, the A–IRB capital charge for a securitization tranche would depend on six institution-supplied inputs:[38] the notional amount of underlying exposures that have been securitized (E), the A–IRB capital charge had the underlying exposures not been securitized (KIRB); the tranche's credit enhancement level (L); the tranche's thickness (T); the pool's effective number of exposures (N); and the pool's exposure-weighted average loss-given-default (LGD). In general, the estimates of N and LGD would be developed as a by-product of the process used to determine KIRB.

The SFA capital charge for a given securitization tranche would be calculated as the notional amount of underlying exposures that have been securitized (E), multiplied by the greater of: (i) 0.0056 * T or (ii) the following expression:[39]

$$K[L+T]-K[L]+\{(0.05 * d * KIRB * e^{-20(L-KIRB)/KIRB}) * (1-e^{-20T/KIRB})\},$$

where,[40]

$$h=(1-KIRB/LGD)^{N}$$

$$c=KIRB/(1-h)$$

$$v=\frac{(LGD-KIRB)\ KIRB+0.25\ (1-LGD)\ KIRB}{N}$$

$$f=\left(\frac{v+KIRB^{2}}{1-h}-c^{2}\right)+\frac{(1-KIRB)\ KIRB-v}{(1-h)*1000}$$

$$g=\frac{(1-c)\ c}{f}-1$$

$$a=g*c$$

$$b=g*(1-c)$$

$$d=1-(1-h)*(1-\text{Beta}\ [KIRB;\ a,b])$$

$$K[x]=(1-h)*(x*(1-\text{Beta}\ [x;\ a,b])+c*\text{Beta}[x;\ a+1,b]).$$

Although visually daunting, the above supervisory formula is easily programmable within standard spreadsheet packages, and its various components have intuitive interpretations.

Part (i), noted above, of the SFA effectively imposes a 56 basis point minimum or floor A–IRB capital charge per dollar of tranche exposure. While acknowledging that such a floor is not risk-sensitive, the Agencies believe that some minimum prudential capital charge is nevertheless appropriate. The

[38] When the banking organization holds only a proportional interest in the tranche, that position's A–IRB capital charge equals the prorated share of the capital charge for the entire tranche.

[39] The SFA applies only to exposures above KIRB. When a securitization tranche straddles KIRB, for the purpose of applying the SFA the tranche should be decomposed into a position at or below KIRB and another above KIRB. The latter would be the position to which the SFA is actually applied.

[40] In these expressions, Beta[X; a, b] refers to the cumulative beta distribution with parameters a and b evaluated at X. The cumulative beta distribution function is available in Excel as the function BETADIST.

floor has been proposed at 56 basis points partly on the basis of empirical analyses suggesting that, across a broad range of modeling assumptions and exposure types, this level provides a reasonable lower bound on the capital charges implied by standard credit risk models for securitization tranches meeting the standards for an external rating of AAA.[41] This floor also is consistent with the lowest capital charge available under the RBA.

Part (ii) of the SFA also is a blend of credit risk modeling results and supervisory judgment. The function denoted K[*x*] represents a pure model-based estimate of the pool's aggregate systematic or non-diversifiable credit risk that is attributable to a first-loss position covering pool losses up to and including *x*. Because the tranche of interest (defined in terms of a credit enhancement level L, and thickness T) covers losses between L and L+T, its total systematic risk can be represented as K[L + T] − K[L], which are the first two terms in (1). The term in braces within (1) represents a supervisory add-on to the pure model-based result. This add-on is intended primarily to avoid potential behavioral distortions associated with what would otherwise be a discontinuity in capital charges for relatively thin mezzanine tranches lying just below and just above KIRB: all tranches at or below KIRB would be deducted from capital, whereas a very thin tranche just above KIRB would incur a pure model-based capital charge that could vary between zero and one, depending upon the number of effective underlying exposures in the pool (N). The add-on would apply primarily to positions just above KIRB, and its quantitative effect would diminish rapidly as the distance from KIRB widens.

Most of the complexity of the supervisory formula is a consequence of attempting to make K[*x*] as consistent as possible with the parameters and assumptions of the A–IRB framework that would apply to the underlying exposures if held directly by a banking organization.[42] The specification of K[*x*] assumes that KIRB is an accurate measure of the pool's total systematic credit risk, and that a securitization merely redistributes this systematic risk among its various tranches. In this way, K[*x*] embodies precisely the same asset correlations as are assumed elsewhere within the A–IRB framework. In addition, this specification embodies the well-known result that a pool's total systematic risk (that is, KIRB) tends to be redistributed toward more senior tranches as the effective number of underlying exposures in the pool (N) declines.[43] The importance of pool granularity depends on the pool's average loss-rate-given-default, as increases in LGD also tend to shift systematic risk toward senior tranches when N is small. For highly granular pools, such as securitizations of retail exposures, LGD would have no influence on the SFA capital charge.

The Agencies propose to establish criteria for determining E, KIRB, L, T, N, and LGD that are consistent with those suggested in the New Accord. A summary of these requirements is presented below.

E. This input would be measured (in dollars) as the A–IRB estimate of the exposures in the underlying pool of securitized exposures, as if they were held directly by the banking organization, rather than securitized. This amount would reflect only those underlying exposures that have actually been securitized to date. Thus, for example, E would exclude undrawn lines associated with revolving credit facilities (for example, credit card accounts).

KIRB. This input would be measured (in decimal form) as the ratio of (a) the pool's A–IRB capital requirement to (b) the notional or loan equivalent amount of the underlying exposures in the pool (E). The pool's A–IRB capital requirement would be calculated in accordance with the applicable A–IRB standard for the type of underlying exposure. This calculation would incorporate the effect of any credit risk mitigant that is applied to the underlying exposures (either individually or to the entire pool), and hence benefits all of the securitization exposures. Consistent with the measurement of E, the estimate of KIRB would reflect only the underlying exposures that have been securitized. For example, KIRB generally would exclude the A–IRB capital charges against the undrawn portions of revolving credit facilities.

Credit enhancement level (L). This input would be measured (in decimal form) as the ratio of (a) the notional amount of all securitization exposures subordinate to the tranche of interest to (b) the notional or loan equivalent amount of underlying exposures in the pool (E). L would incorporate any funded reserve account (for example, spread account or overcollateralization) that provides credit enhancement to the tranche of interest. Credit-enhancing interest-only strips would not be included in the calculation of L.

Thickness (T). This input would be measured (in decimal form) as the ratio of (a) the notional amount of the tranche of interest to (b) the notional or loan equivalent amount of underlying exposures in the pool (E).

Effective number of exposures (N). This input would be calculated as

$$N = \frac{\left(\sum_i \mathrm{EAD}_i\right)^2}{\sum_i \mathrm{EAD}_i^2}$$

where EAD_i represents the exposure-at-default associated with the i-th underlying exposure in the pool. Multiple underlying exposures to the same obligor would be consolidated (that is, treated as a single exposure). If the pool contains any underlying exposures that are themselves securitization exposures (for example, one or more asset-backed securities), each of these would be treated as a single exposure for the purpose of measuring N.[44]

Exposure-weighted average LGD. This input would be calculated (in decimal form) as

$$\mathrm{LGD} = \frac{\sum_i \mathrm{LGD}_i \cdot \mathrm{EAD}_i}{\sum_i \mathrm{EAD}_i}$$

where LGD_i represents the average LGD associated with all underlying exposures to the i-th obligor. In the case of re-securitization (a securitization of securitization exposures), an LGD of 100 percent would be assumed for any underlying exposure that was itself a securitization exposure.[45]

[41] See Vladislav Peretyatkin and William Perraudin, ''Capital for Asset-Backed Securities,'' Bank of England, February 2003.

[42] The conceptual basis for specification of K[*x*] is developed in Michael B. Gordy and David Jones, ''Random Tranches,'' *Risk* (March 2003) 78–83.

[43] See Michael Pykhtin and Ashish Dev, ''Coarse-granied CDOs,'' *Risk* (January 2003) 113–116.

[44] Within the supervisory formula, the probability distribution of credit losses associated with the pool of underlying exposures is approximated by treating the pool as if it consisted of N homogeneous exposures, each having an A–IRB capital charge of KIRB/N. The proposed treatment of N implies, for example, that a pool containing one ABS tranche backed by 1 million effective loans behaves more like a single loan having an A–IRB capital charge of KIRB than a pool of 1 million loans, each having an A–IRB capital charge of KIRB/1,000,000.

[45] As noted above, the A–IRB securitization framework does not permit banking organizations to use their own internal estimates of LGDs (and PDs) for securitization exposures because such quantification requires implicit or explicit estimates of loss correlations among the underlying exposures. Recall that LGDs should be measured as the loss rates expected to prevail when default rates are high. While setting LGDs equal to 100 percent is reasonable for certain types of ABSs, such as highly subordinated or thin tranches, this level of

Continued

Simplified method for computing N and LGD. Under the conditions provided below, banking organizations would be able to employ simplified methods for calculating N and the exposure-weighted average LGD. When the underlying exposures are retail exposures, the SFA may be implemented by setting h = 0 and v = 0, subject to supervisory approval and review. When the share of the pool associated with the largest exposure, C_1, is no more than 0.03 (or 3 percent of the pool), the banking organization would be able to set LGD = 0.50 and N equal to:

$$N = \left(C_1 C_m + \left(\frac{C_m - C_1}{m - 1} \right) \max\{1 - mC_1, 0\} \right)^{-1},$$

provided that the banking organization can measure C_m, which denotes the share of the pool corresponding to the largest ''m'' exposures (for example, a 15 percent share corresponds to a value of 0.15).[46] Alternatively, when only C_1 is available and this amount is no more than 0.03, then the banking organization would be able to set LGD = 0.50 and N = 1/ C_1.

The Agencies seek comment on the proposed SFA. How might it be simplified without sacrificing significant risk sensitivity? How useful are the alternative simplified computation methodologies for N and LGD

The Look-Through Approach for Eligible Liquidity Facilities

ABCP conduits and similar programs sponsored by U.S. banking organizations are major sources of funding for financial and non-financial companies. Liquidity facilities supporting these programs are considered to be securitization exposures of the banking organizations providing the liquidity, and generally would be treated under the rules proposed for originators. As a general matter, the Agencies expect that banking organizations using the A–IRB approach would apply the SFA when determining the A–IRB capital requirement for liquidity facilities provided to ABCP conduits and similar programs. However, if it would not be practical for a banking organization to calculate KIRB for the underlying exposures using a top-down or a bottom-up approach, the banking organization may be allowed to use the Look-Through Approach, described below, for determining the A–IRB capital requirement, subject to supervisory approval and only for a temporary period of time to be determined in consultation with the organization's primary Federal supervisor.

Because the Look-Through Approach has limited risk sensitivity, the Agencies propose that its applicability be restricted to liquidity facilities that are structured to minimize the extent to which the facilities provide credit support to the conduit. The Look-Through Approach would only be available to liquidity facilities that meet the following criteria:

(a) The facility documentation clearly identifies and limits the circumstances under which it may be drawn. In particular, the facility must not be able to cover losses already sustained by the pool of underlying exposures (for example, to acquire assets from the pool at above fair value) or be structured such that draw-down is highly probable (as indicated by regular or continuous draws);

(b) The facility is subject to an asset quality test that prevents it from being drawn to cover underlying exposures that are in default;

(c) The facility cannot be drawn after all applicable (specific and program-wide) credit enhancements from which the liquidity facility would benefit have been exhausted;

(d) Repayment of any draws on the facility (that is, assets acquired under a purchase agreement or loans made under a lending agreement) may not represent a subordinated obligation of the pool or be subject to deferral or waiver; and

(e) Reduction in the maximum drawn amount, or early termination of the facility, occurs if the quality of the pool falls below investment grade.

Under the Look-Through Approach, the liquidity facility's A–IRB capital charge would be computed as the product of (a) 8 percent, (b) the maximum potential drawdown under the facility, (c) the applicable credit conversion factor (CCF), and (d) the applicable risk weight. The CCF would be set at 50 percent if the liquidity facility's original maturity is one year or less, and at 100 percent if the original maturity is more than one year. The Agencies propose that the risk weight be set equal to the risk weight applicable under the general risk-based capital rules for banking organizations not using the A–IRB approach (that is, to the underlying assets or obligors after consideration of collateral or guarantees or, if applicable, external ratings).

The Agencies seek comment on the proposed treatment of eligible liquidity facilities, including the qualifying criteria for such facilities. Does the proposed Look-Through Approach—to be available as a temporary measure—satisfactorily address concerns that, in some cases, it may be impractical for providers of liquidity facilities to apply either the ''bottom-up'' or ''top-down'' approach for calculating KIRB? It would be helpful to understand the degree to which any potential obstacles are likely to persist.

Feedback also is sought on whether liquidity providers should be permitted to calculate A–IRB capital charges based on their internal risk ratings for such facilities in combination with the appropriate RBA risk weight. What are the advantages and disadvantages of such an approach, and how might the Agencies address concerns that the supervisory validation of such internal ratings would be difficult and burdensome? Under such an approach, would the lack of any maturity adjustment with the RBA be problematic for assigning reasonable risk weights to liquidity facilities backed by relatively short-term receivables, such as trade credit?

Other Considerations

Capital Treatment Absent an A–IRB Approach—The Alternative RBA

For originating banking organizations when there is not a specific A–IRB treatment for an underlying exposure or group of underlying exposures, the Agencies propose that a securitization exposure's A–IRB capital charge be based exclusively on the exposure's external or inferred credit rating using

LGD may be conservative for other types of ABSs. However, the Agencies believe that the complexity and burden assoicated with a more refined treatment of LGDs would outweigh any improvement in the overall risk sensitivity of A–IRB capital charges for originators, owing to the combined effects of (a) the dollar-for-dollar A–IRB capital charge on positions at or below KIRB, and (b) the maximum or cap on an originator's total A–IRB capital charge.

[46] The level of m is to be set by each banking organization.

[47] The Alternative RBA does not apply to eligible liquidity facilities, which may use the Look-

the Alternative RBA.[47] Under the Alternative RBA, a risk weight of 20 percent is applied to exposures rated AAA to AA−, 50 percent to exposures rated A+ to A−, and 100 percent to exposures rated BBB+ to BBB-. Securitization exposures having ratings below investment grade, or that are non-rated, would be deducted from risk-based capital on a dollar-for-dollar basis.

Should the A–IRB capital treatment for securitization exposures that do not have a specific A–IRB treatment be the same for investors and originators? If so, which treatment should be applied—that used for investors (the RBA) or originators (the Alternative RBA)? The rationale for the response would be helpful.

Structures With Early Amortization Provisions

Many securitizations of revolving credit facilities (for example, credit card accounts) contain provisions that call for the securitization to be wound down if the excess spread falls below a certain threshold.[48] This decrease in excess spread can, in some cases, be caused by deterioration in the credit quality of the underlying exposures. An early amortization event can increase a banking organization's capital needs if any new draws on the revolving facilities would need to be financed by the banking organization itself using on-balance-sheet sources of funding. The payment allocations used to distribute principal and finance charge collections during the amortization phase of these structures also can expose a banking organization to greater risk of loss than in other securitization structures. To account for the risks that early amortization structures pose to originating banking organizations, the capital treatment described below would apply to securitizations of revolving credit facilities containing such features.

In addition to the A–IRB capital charge an originating banking organization would incur on the securitization exposures it retains, an originator would be required to hold capital against all or a portion of the investors' interest in a securitization when (i) the organization sells exposures into a securitization that contains an early amortization feature, and (ii) the underlying exposures sold are of a revolving nature. The A–IRB capital charge attributed to the originator that is associated with the investors' interest is calculated as the product of (a) the A–IRB capital charge that would be imposed on the entire investors' interest if it were held by the originating banking organization, and (b) an applicable CCF.

In general, the CCF would depend on whether the early amortization feature repays investors through a controlled or non-controlled mechanism, and whether the underlying exposures represent uncommitted revolving retail facilities that are unconditionally cancellable without prior notice (for example, credit card receivables) or other credit lines (for example, revolving corporate facilities).

An early amortization provision would be considered controlled if, throughout the duration of the securitization transaction, including the amortization period, there is a pro rata sharing of interest, principal, expenses, losses, and recoveries based on the balances of receivables outstanding at the beginning of each month. Further, the pace of repayment may not be any more rapid than would be allowed through straight-line amortization over a period sufficient for 90 percent of the total debt outstanding at the beginning of the early amortization period to have been repaid or recognized as in default. In addition to these criteria, banking organizations with structures containing controlled early amortization features would also have to have appropriate plans in place to ensure that there is sufficient capital and liquidity available in the event of an early amortization. When these conditions are not met, the early amortization provision would be treated as non-controlled.

Determination of CCFs for Controlled Early Amortization Structures

The following method for determining CCFs applies to a securitization of revolving credit facilities containing a controlled early amortization mechanism. When the pool of underlying exposures includes uncommitted retail credit lines (for example, credit card receivables), an originator would first compare the securitization's three-month average excess spread against the following two reference levels:

A. The point at which the banking organization would be required to trap excess spread under the terms of the securitization; and

B. The excess spread level at which an early amortization would be triggered.

In cases where a transaction does not require excess spread to be trapped, the first trapping point would be deemed to be 4.5 percentage points greater than the excess spread level at which an early amortization is triggered.

The banking organization would divide the distance between the two points described above into four equal segments. For example if the spread trapping point is 4.5 percent and the early amortization trigger is zero percent, then 4.5 percent would be divided into four equal segments of 112.5 basis points each. The following conversion factors, based on illustrative segments, would apply to the investors' interest.

CONTROLLED EARLY AMORTIZATION OF UNCOMMITTED RETAIL CREDIT LINES

3-month average excess spread	Credit Conversion Factor (CCF) (percent)
450 basis points (bp) or more	0
Less than 450 bp to 337.5 bp	1
Less than 337.5 bp to 225 bp	2
Less than 225 bp to 112.5 bp	20
Less than 112.5 bp	40

All other securitizations of revolving facilities (that is, those containing underlying exposures that are committed or non-retail) having controlled early amortization features would be subject to a CCF of 90 percent.

Determination of CCFs for Non-Controlled Early Amortization Structures

The process for determining CCFs when a securitization of revolving credit facilities contains a non-controlled early amortization mechanism would be the same as that described above for controlled early amortization structures, except that different CCFs would apply to the various excess spread segments. For non-controlled structures, the following conversion factors, based on illustrative segments, would apply:

NON-CONTROLLED EARLY AMORTIZATION OF UNCOMMITTED RETAIL CREDIT LINES

3-month average excess spread	Credit Conversion Factor (CCF) (percent)
450 basis points (bp) or more	0
Less than 450 bp to 337.5 bp	5

Through Approach as described above. Additionally, the securitization exposures subject to the Alternative RBA are not limited by the maximum capital requirement discussed above.

48 Excess spread is defined as gross finance charge collections and other income received by the trust or special purpose entity (SPE) minus certificate interest, servicing fees, charge-offs, and other senior trust or SPE expenses.

29 A banking organization is generally considered a sponsor of an ABCP conduit or similar program if, in fact or in substance, it manages or advises the conduit program, places securities into the market for the program, or provides liquidity support or credit enhancements to the program.

NON-CONTROLLED EARLY AMORTIZATION OF UNCOMMITTED RETAIL CREDIT LINES—Continued

3-month average excess spread	Credit Conversion Factor (CCF) (percent)
Less than 337.5 bp to 225 bp	10
Less than 225 bp to 112.5 bp	50
Less than 112.5 bp	100

All other securitizations of revolving credit facilities (that is, those containing underlying exposures that are committed or non-retail) having non-controlled early amortization mechanisms would be subject to a CCF of 100 percent. In other words, no risk transference would be recognized for these structures; an originator's A–IRB capital charge would be the same as if the underlying exposures had not been securitized.

The Agencies seek comment on the proposed treatment of securitization of revolving credit facilities containing early amortization mechanisms. Does the proposal satisfactorily address the potential risks such transactions pose to originators?

Comments are invited on the interplay between the A–IRB capital charge for securitization structures containing early amortization features and that for undrawn lines that have not been securitized. Are there common elements that the Agencies should consider? Specific examples would be helpful.

Are proposed differences in CCFs for controlled and non-controlled amortization mechanisms appropriate? Are there other factors that the Agencies should consider?

Market-Disruption Eligible Liquidity Facilities

A banking organization would be able to apply a 20 percent CCF to an eligible liquidity facility that can be drawn only in the event of a general market disruption (that is, where a capital market instrument cannot be issued at any price), provided that any advance under the facility represents a senior secured claim on the assets in the pool. A banking organization using this treatment would recognize 20 percent of the A–IRB capital charge required for the facility through use of the SFA. If the market disruption eligible liquidity facility is externally rated, a banking organization would be able to rely on the external rating under the RBA for determining the A–IRB capital requirement provided the organization assigns a 100 percent CCF rather than a 20 percent CCF to the facility.

Overlapping Credit Enhancements or Liquidity Facilities

In some ABCP or similar programs, a banking organization may provide multiple facilities that may be drawn under varying circumstances. The Agencies do not intend that a banking organization incur duplicative capital requirements against these multiple exposures as long as, in the aggregate, multiple advances are not permitted against the same collateral. Rather, a banking organization would be required to hold capital only once for the exposure covered by the overlapping facilities (whether they are general liquidity facilities, eligible liquidity facilities, or the facilities serve as credit enhancements). Where the overlapping facilities are subject to different conversion factors, the banking organization would attribute the overlapping part to the facility with the highest conversion factor. However, if different banking organizations provide overlapping facilities, each institution would hold capital against the entire maximum amount of its facility. That is, there may be some duplication of capital charges for overlapping facilities provided by multiple banking organizations.

Servicer Cash Advances

Subject to supervisory approval, servicer cash advances that are recoverable would receive a zero percent CCF. This treatment would apply when servicers, as part of their contracts, may advance cash to the pool to ensure an uninterrupted flow of payments to investors, provided the servicer is entitled to full reimbursement and this right is senior to other claims on cash flows from the pool of underlying exposures.

When providing servicer cash advances, are banking organizations obligated to advance funds up to a specified recoverable amount? If so, does the practice differ by asset type? Please provide a rationale for the response given.

Credit Risk Mitigation

For securitization exposures covered by collateral or guarantees, the credit risk mitigation rules discussed earlier would apply. For example, a banking organization may reduce the A–IRB capital charge when a credit risk mitigant covers first losses or losses on a proportional basis. For all other cases, a banking organization would assume that the credit risk mitigant covers the most senior portion of the securitization exposure (that is, that the most junior portion of the securitization exposure is uncovered).

V. AMA Framework for Operational Risk

This section describes features of the proposed AMA framework for measuring the regulatory capital requirement for operational risk. Under this framework, a banking organization meeting the AMA supervisory standards would use its internal operational risk measurement system to calculate its regulatory capital requirement for operational risk. The discussion below provides background information on operational risk and the conceptual underpinnings of the AMA, followed by a discussion of the AMA supervisory standards.[49]

The Agencies' general risk-based capital rules do not currently include an explicit capital charge for operational risk, which is defined as the risk of loss resulting from inadequate or failed processes, people, and systems or from external events. When developing the general risk-based capital rules, the Agencies recognized that institutions were exposed to non-credit related risks, including operational risk. Consequently, the Agencies built a ''buffer'' into the general risk-based capital rules to implicitly cover other risks such as operational risk. With the introduction of the A–IRB framework for credit risk in this ANPR, which results in a more risk-sensitive treatment of credit risk, there is no longer an implicit capital buffer for other risks.

The Agencies recognize that operational risk is a key risk in financial institutions, and evidence indicates that a number of factors are driving increases in operational risk. These include the recent experience of a number of high-profile, high-severity losses across the banking industry highlighting operational risk as a major source of unexpected losses. Because the regulatory capital buffer for operational risk would be removed under the proposal, the Agencies are now seeking comment on a risk-sensitive capital framework for the largest, most complex institutions that would include an explicit risk-based capital requirement for operational risk. The Agencies propose to require banking organizations using the A–IRB approach for credit risk also to use the AMA to compute capital charges for operational risk.

[49] For a more detailed discussion of the concepts set forth in this ANPR and definitions of relevant terms, see the accompanying interagency ''Supervisory Guidance on Operational Risk Advanced Measurement Approaches for Regulatory Capital'' (supervisory guidance) published elsewhere in today's **Federal Register**.

The Agencies are proposing the AMA to address operational risk for regulatory capital purposes. The Agencies are interested, however, in possible alternatives. Are there alternative concepts or approaches that might be equally or more effective in addressing operational risk? If so, please provide some discussion on possible alternatives.

A. AMA Capital Calculation

The AMA capital requirement would be based on the measure of operational risk exposure generated by a banking organization's internal operational risk measurement system. In calculating the operational risk exposure, an AMA-qualified institution would be expected to estimate the aggregate operational risk loss that it faces over a one-year period at a soundness standard consistent with a 99.9 percent confidence level. The institution's AMA capital requirement for operational risk would be the sum of EL and UL, unless the institution can demonstrate that an EL offset would meet the supervisory standards for operational risk. The institution would have to use a combination of internal loss event data, relevant external loss event data, business environment and internal control factors, and scenario analysis in calculating its operational risk exposure. The institution also would be allowed to recognize the effect of risk dependency (for example, correlation) and, to a limited extent, the effect of insurance as a risk mitigant.

As with the proposed A–IRB capital requirement for credit risk, the operational risk exposure would be converted to an equivalent amount of risk-weighted assets for the calculation of an institution's risk-based capital ratios. An AMA-qualified institution would multiply the operational risk exposure generated by its analytical framework by a factor of 12.5 to convert the exposure to a risk-weighted assets equivalent. The resulting figure would be added to the comparable figures for credit and market risk in calculating the institution's risk-based capital denominator.

Does the broad structure that the Agencies have outlined incorporate all the key elements that should be factored into the operational risk framework for regulatory capital? If not, what other issues should be addressed? Are any elements included not directly relevant for operational risk measurement or management? The Agencies have not included indirect losses (for example, opportunity costs) in the definition of operational risk against which institutions would have to hold capital; because such losses can be substantial, should they be included in the definition of operational risk?

Overview of the Supervisory Criteria

Use of the AMA would be subject to supervisory approval. A banking organization would have to demonstrate that it has satisfied all supervisory standards before it would be able to use the AMA for risk-based capital purposes. The supervisory standards are briefly described below. Because an institution would have significant flexibility to develop its own methodology for calculating its risk-based capital requirement for operational risk, it would be necessary for supervisors to ensure that the institution's methodology is fundamentally sound. In addition, because different institutions may adopt different methodologies for assessing operational risk, the requirement to satisfy supervisory standards offers some assurance to institutions and their supervisors that all AMA-qualified institutions would be subject to a common set of standards.

While the supervisory standards are rigorous, institutions would have substantial flexibility in terms of how they satisfy the standards in practice. This flexibility is intended to encourage an institution to adopt a system that is responsive to its unique risk profile, foster improved risk management, and allow for future innovation. The Agencies recognize that operational risk measurement is evolving rapidly and wish to encourage continued evolution and innovation. Nevertheless, the Agencies also acknowledge that this flexibility would make cross-institution comparisons more difficult than if a single supervisory approach were to be mandated for all institutions. The supervisory standards outlined below are intended to allow flexibility while also being sufficiently objective to ensure consistent supervisory assessment and enforcement of standards across institutions.

The Agencies seek comment on the extent to which an appropriate balance has been struck between flexibility and comparability for the operational risk requirement. If this balance is not appropriate, what are the specific areas of imbalance and what is the potential impact of the identified imbalance?

The Agencies are considering additional measures to facilitate consistency in both the supervisory assessment of AMA frameworks and the enforcement of AMA standards across institutions. Specifically, the Agencies are considering enhancements to existing interagency operational and managerial standards to directly address operational risk and to articulate supervisory expectations for AMA frameworks. The Agencies seek comment on the need for and effectiveness of these additional measures.

The Agencies also seek comment on the supervisory standards. Do the standards cover the key elements of an operational risk framework?

An institution's operational risk framework would have to include an independent operational risk management function, line of business oversight, and independent testing and verification. Both the institution's board of directors and management would have to have responsibilities in establishing and overseeing this framework. The institution would have to have clear policies and procedures in place for identifying, measuring, monitoring, and controlling operational risk.

An institution would have to establish an analytical framework that incorporates internal operational loss event data, relevant external loss event data, assessments of the business environment and internal control factors, and scenario analysis. The institution would have to have standards in place to capture all of these elements. The combination of these elements would determine the institution's quantification of operational risk and related regulatory capital requirement.

The supervisory standards for the AMA have both quantitative and qualitative elements. Effective operational risk quantification is critical to the objective of a risk-sensitive capital requirement. Consequently, a number of the supervisory standards are aimed at ensuring the integrity of the process by which an institution arrives at its estimated operational risk exposure.

It is not sufficient, however, to focus solely on operational risk measurement. If the Agencies are to rely on institutions to determine their risk-based capital requirements for operational risk, there would have to be assurances that institutions have in place sound operational risk management infrastructures. In addition, risk management elements would be critical inputs into the quantification of operational risk exposure, that is, operational risk quantification would have to take into account such risk management elements as the quality of an institution's internal controls. Likewise, the AMA capital requirement derived from an institution's quantification methodology would need to offer incentives for an institution to improve its operational risk management practices. Ultimately, the Agencies believe that better operational risk management will enhance operational risk measurement, and vice versa.

Corporate Governance

An institution's operational risk framework would have to include an independent firm-wide operational risk management function, line of business management oversight, and independent testing and verification functions. While no specific management structure would be mandated, all three components would have to be evident.

The institution's board of directors would have to oversee the development of the firm-wide operational risk framework, as well as major changes to the framework. Management roles and accountability would have to be clearly established. The board and management would have to ensure that appropriate resources have been allocated to support the operational risk framework.

The independent firm-wide operational risk management function would be responsible for overseeing the operational risk framework at the firm level to ensure the development and consistent application of operational risk policies, processes, and procedures throughout the institution. This function would have to be independent from line of business management and the testing and verification functions. The firm-wide operational risk management function would have to ensure appropriate reporting of operational risk exposures and loss data to the board and management.

Lines of business would be responsible for the day-to-day management of operational risk within each business unit. Line of business management would have to ensure that internal controls and practices within their lines of business are consistent with firm-wide policies and procedures that support the management and measurement of the institution's operational risk.

The Agencies are introducing the concept of an operational risk management function, while emphasizing the importance of the roles played by the board, management, lines of business, and audit. Are the responsibilities delineated for each of these functions sufficiently clear and would they result in a satisfactory process for managing the operational risk framework?

Operational Risk Management Elements

An institution would have to have policies and procedures that clearly describe the major elements of its operational risk framework, including identifying, measuring, monitoring, and controlling operational risk. Management reports would need to be developed to address both firm-wide and line of business results. These reports would summarize operational risk exposure, operational loss experience, and relevant assessments of business environment and internal control factors, and would have to be produced at least quarterly. Operational risk reports, which summarize relevant firm-wide operational risk information, would also have to be provided periodically to senior management and the board. An institution's internal control system and practice would have to be adequate in view of the complexity and scope of its operations. In addition, an institution would be expected to meet or exceed minimum supervisory standards as set forth in the Agencies' supervisory policy statements and other guidance.

B. Elements of an AMA Framework

An institution would have to demonstrate that it has adequate internal loss event data, relevant external loss event data, assessments of business environments and internal control factors, and scenario analysis to support its operational risk management and quantification framework. These inputs would need to be consistent with the regulatory definition of operational risk. The institution would have to have clear standards for the collection and modification of operational risk inputs.

There are a number of standards that banking organizations would have to meet with respect to internal operational loss data. Institutions would have to have at least five years of internal operational risk loss data captured across all material business lines, events, product types, and geographic locations.[50] An institution would have to establish thresholds above which all internal operational losses would be captured. The New Accord introduces seven loss event type classifications; the Agencies are not proposing that an institution would be required to internally manage its operational risk according to these specific loss event type classifications, but nevertheless it would have to be able to map its internal loss data to these loss event categories. The institution would have to provide consistent treatment for the timing of reporting an operational loss in its internal data systems. As highlighted earlier in this ANPR, credit losses caused or exacerbated by operational risk events would be treated as credit losses for regulatory capital purposes; these would include fraud-related credit losses.

[50] With supervisory approval, a shorter initial observation period may be acceptable for institutions that are newly authorized to use an AMA methodology.

An institution would have to establish and adhere to policies and procedures that provide for the use of relevant external loss data in the operational risk framework. External data would be particularly relevant where an institution's internal loss history is not sufficient to generate an estimate of major unexpected losses. Management would have to systematically review external data to ensure an understanding of industry experience. The Agencies seek comment on the use of external data and its optimal function in the operational risk framework.

While internal and external data provide an important historic picture of an institution's operational risk profile, it is important that institutions take a forward-looking view as well. Consequently, an institution would have to incorporate assessments of the business environment and internal control factors (for example, audit scores, risk and control assessments, risk indicators, *etc.*) into its AMA capital assessment. In addition, an institution would have to periodically compare its assessment of these factors with actual operational loss experience.

Another element of the AMA framework is scenario analysis. Scenario analysis is a systematic process of obtaining expert opinions from business managers and risk management experts to derive reasoned assessments of the likelihood and impact of plausible operational losses consistent with the regulatory soundness standard. While scenario analysis may rely, to a large extent, on internal or, especially, external data (for example, where an institution looks to industry experience to generate plausible loss scenarios), it is particularly useful where internal and external data do not generate a sufficient assessment of the institution's operational risk profile.

An institution would be required to have a comprehensive analytical framework that provides an estimate of the aggregate operational loss that it faces over a one-year period at a soundness standard consistent with a 99.9 percent confidence level. The institution would have to document the rationale for all assumptions underpinning its chosen analytical framework, including the choice of inputs, distributional assumptions, and weighting of quantitative and qualitative elements. The institution would also have to document and justify any subsequent changes to these assumptions.

An institution's operational risk analytical framework would have to use a combination of internal operational loss event data, relevant external operational loss event data, business environment and control factors, as well as scenario analysis. The institution would have to combine these elements in the manner that most effectively enables it to quantify its operational risk exposure. The institution would have to develop an analytical framework that is appropriate to its business model and risk profile.

Regulatory capital for operational risk would be based on the sum of EL and UL. There may be instances where an EL offset could be recognized, but the Agencies believe that this is likely to be difficult given existing supervisory and accounting standards. The Agencies have considered both reserving and budgeting as potential mechanisms for EL offsets. The use of reserves may be hampered by accounting standards, while budgeting raises concerns about availability over a one-year time horizon to act as a capital replacement mechanism. The Agencies are interested in specific examples of how business practices might be used to offset EL in the operational risk framework.

An institution would have to document how its chosen analytical framework accounts for dependence (for example, correlation) among operational losses across and within business lines. The institution would have to demonstrate that its explicit and embedded dependence assumptions are appropriate, and where dependence assumptions are uncertain, the institution would have to use conservative estimates.

An institution would be able to reduce its operational risk exposure by no more than 20 percent to reflect the impact of risk mitigants such as insurance. Institutions would have to demonstrate that qualifying risk mitigants meet a series of criteria (described in the supervisory guidance) to assess whether the risk mitigants are sufficiently capital-like to warrant a reduction of the operational risk exposure.

The Agencies seek comment on the reasonableness of the criteria for recognition of risk mitigants in reducing an institution's operational risk exposure. In particular, do the criteria allow for recognition of common insurance policies? If not, what criteria are most binding against current insurance products? Other than insurance, are there additional risk mitigation products that should be considered for operational risk?

An institution using an AMA for regulatory capital purposes would have to use advanced data management practices to produce credible and reliable operational risk estimates. These practices are comparable to the data maintenance requirements set forth under the A–IRB approach for credit risk.

The institution would have to test and verify the accuracy and appropriateness of the operational risk framework and results. Testing and verification would have to be done independently of the firm-wide risk management function and the lines of business.

VI. Disclosure

Market discipline is a key component of the New Accord. The disclosure requirements summarized below seek to enhance the public disclosure practices, and thereby the transparency, of advanced approach organizations. Commenters are encouraged to consult the New Accord for specifics on the disclosure requirements under consideration. The Agencies view enhanced market discipline as an important complement to the advanced approaches to calculating minimum regulatory capital requirements, which would be heavily based on internal methodologies. Increased disclosures, especially regarding a banking organization's use of the A–IRB approach for credit risk and the AMA for operational risk, would allow a banking organization's private sector investors to more fully evaluate the institution's financial condition, risk profile, and capital adequacy. Given better information, private shareholders and debt holders can better influence the funding and capital costs of a banking organization. Such actions would enhance market discipline and supplement supervisory oversight of the organization's risk-taking and management.

A. Overview

Disclosure requirements would apply to the bank holding company representing the top consolidated level of the banking group. Individual banks within the holding company or consolidated group would not generally be required to fulfill the disclosure requirements set out below. An exception to the general rule would be that individual banks and thrifts within a group would still be required to disclose Tier 1 and total capital ratios and their components (that is, Tier 1, Tier 2, and Tier 3 capital), as is the case today. In addition, all banks and thrifts would continue to be required to submit appropriate information to regulatory authorities (for example, Report of Condition of Income (Call Reports) or Thrift Financial Reports).[51]

The Agencies are proposing a set of disclosure requirements that would allow market participants to assess key pieces of information regarding a banking group's capital structure, risk exposures, risk assessment processes, and ultimately, the capital adequacy of the institution. Failure to meet these minimum disclosure requirements, if not corrected, would render a banking organization ineligible to use the advanced approaches or would otherwise cause the banking organization to forgo potential capital benefits arising from the advanced approaches. In addition, other supervisory measures may be taken if appropriate.

Management would have some discretion to determine the appropriate medium and location of the required disclosure. Disclosures made in public financial reports (for example, in financial statements or Management's Discussion and Analysis included in periodic reports or SEC filings) or other regulatory reports (for example, FR Y–9C Reports), could fulfill the applicable disclosure requirements and would not need to be repeated elsewhere. For those disclosures that are not made under accounting or other requirements, the Agencies are seeking comment on the appropriate means of providing this data to market participants. Institutions would be encouraged to provide all related information in one location; at a minimum, institutions would be required to provide a cross reference to the location of the required disclosures.

The Agencies intend to maximize a banking organization's flexibility regarding where to make the required disclosures while ensuring that the information is readily available to market participants without unnecessary burden. To balance these contrasting objectives, the Agencies are considering requiring banking organizations to provide a summary table on their public websites that indicate where all disclosures may be found. Such an approach also would allow institutions to cross-reference other web addresses (for example, those containing public financial reports or regulatory reports or other risk-oriented disclosures) where certain of the disclosures are located.

Given longstanding requirements for robust quarterly disclosure in the United States, and recognizing the potential for rapid change in risk profiles, the Agencies intend to require that the disclosures be made on a

[51] In order to meet supervisory responsibilities, the Agencies plan to collect more detailed information through the supervisory process or regulatory reports. Much of this information may be proprietary and accordingly would not be made public.

quarterly basis. However, qualitative disclosures that provide a general summary of a banking organization's risk management objectives and policies, reporting system, and definitions would be able to be published on an annual basis, provided any significant changes to these are disclosed in the interim. When significant events occur, banking organizations would be required to publish material information as soon as practicable rather than at the end of the quarter.

The risks to which banking organizations are exposed and the techniques that they use to identify, measure, monitor, and control those risks are important factors that market participants consider in their assessment of an institution. Accordingly, banking organizations would be required to have a formal disclosure policy approved by the board of directors that addresses the institution's approach for determining the disclosures it will make. The policy also would have to address the associated internal controls and disclosure controls and procedures. The board of directors and senior management would have to ensure that appropriate verification of the disclosures takes place and that effective internal controls and disclosure controls and procedures are maintained.

Consistent with sections 302 and 404 of the Sarbanes-Oxley Act of 2002, management would have to certify to the effectiveness of internal controls over financial reporting and disclosure controls and procedures, and the banking organization's external auditor would have to attest to management's assertions with respect to internal controls over financial reporting. The scope of these reports would need to include all information included in regulatory reports and the disclosures outlined in this ANPR. Section 36 of the Federal Deposit Insurance Act has similar requirements. Accordingly, banking organizations would have to implement a process for assessing the appropriateness of their disclosures, including validation and frequency. Unless otherwise required by accounting or auditing standards, or by other regulatory authorities, the proposed requirements do not mandate that the new disclosures be audited by an external auditor for purposes of opining on whether the financial statements are presented in accordance with GAAP.

B. Disclosure Requirements

Banking organizations would be required to provide disclosures related to scope of application, capital structure, capital adequacy, credit risk, equities in the banking book, credit risk mitigation, asset securitization, market risk, operational risk and interest rate risk in the banking book. The disclosure requirements are summarized below.

The required disclosures pertaining to the scope of application of the advanced approaches would include a description of the entities found in the consolidated banking group. Additionally, banking organizations would be required to disclose the methods used to consolidate them, any major impediments on the transfer of funds or regulatory capital within the banking group, and specific disclosures related to insurance subsidiaries.

Capital structure disclosures would provide summary information on the terms and conditions of the main features of capital instruments issued by the banking organization, especially in the case of innovative, complex, or hybrid capital instruments. Quantitative disclosures include the amount of Tier 1, Tier 2, and Tier 3 capital, deductions from capital, and total eligible capital.

Capital adequacy disclosures would include a summary discussion of the banking organization's approach to assessing the adequacy of its capital to support current and future activities. These requirements also include a breakdown of the capital requirements for credit, equity, market, and operational risks. Banking organizations also would be required to disclose their Tier 1 and total capital ratios for the consolidated group, as well as those of significant bank or thrift subsidiaries.

For each separate risk area, a banking organization would describe its risk management objectives and policies. Such disclosures would include an explanation of the banking organization's strategies and processes; the structure and organization of the relevant risk management function; the scope and nature of risk reporting and/or measurement systems; and the policies for hedging and/or mitigating risk and strategies and processes for monitoring the continuing effectiveness of hedges/mitigants.

The credit risk disclosure regime is intended to enable market participants to assess the credit risk exposure of A–IRB banking organizations and the overall applicability of the A–IRB framework, without revealing proprietary information or duplicating the role of the supervisor in validating the framework the banking organization has put into place.

Credit risk disclosures would include breakdowns of the banking organization's exposures by type of credit exposure, geographic distribution, industry or counterparty type distribution, residual contractual maturity, amount and type of impaired and past due exposures, and reconciliation of changes in the allowances for exposure impairment.

Banking organizations would provide disclosures discussing the status of the regulatory acceptance process for the adoption of the A–IRB approach, including supervisory approval of such transition. The disclosures would provide an explanation and review of the structure of internal rating systems and relation between internal and external ratings; the use of internal estimates other than for A–IRB capital purposes; the process for managing and recognizing credit risk mitigation; and, the control mechanisms for the rating system including discussion of independence, accountability, and rating systems review. Required qualitative disclosures would include a description of the internal ratings process and separate disclosures pertaining to the banking organization's wholesale, retail and equity exposures.

There would be two categories of quantitative disclosures for credit risk: those that focus on the analysis of risk and those that focus on the actual results. Risk assessment disclosures would include the percentage of total credit exposures to which A–IRB disclosures relate. Also, for each portfolio except retail, the disclosures would have to provide (1) a presentation of exposures across a sufficient number of PD grades (including default) to allow for a meaningful differentiation of credit risk,[52] and (2) the default weighted-average LGD for each PD, and the amount of undrawn commitments and weighted average EAD.[53] For retail portfolios, banking organization would provide either [54] (a) disclosures outlined

[52] Where banking organizations are aggregating PD grades for the purposes of disclosure, this would be a representative breakdown of the distribution of PD grades used in the A–IRB approach.

[53] Banking organizations need only provide one estimate of EAD for each portfolio. However, where banking organizations believe it is helpful, in order to give a more meaningful assessment of risk, they may also disclose EAD estimates across a number of EAD categories, against the undrawn exposures to which these relate.

[54] Banking organizations would normally be expected to follow the disclosures provided for the non-retail portfolios. However, banking organizations would be able to adopt EL grades at the basis of disclosure where they believe this can provide the reader with a meaningful differentiation of credit risk. Where banking organizations are

above on a pool basis (that is, the same as for non-retail portfolios), or (b) analysis of exposures on a pool basis against a sufficient number of EL grades to allow for a meaningful differentiation of credit risk.

Quantitative disclosures pertaining to historical results would include actual losses (for example, charge-offs and specific provisions) in the preceding period for each portfolio and how this differs from past experience and a discussion of the factors that affected the loss experience in the preceding period. In addition, disclosures would include banking organizations' estimates against actual outcomes over a longer period.[55] At a minimum, this would include information on estimates of losses against actual losses in each portfolio over a period sufficient to allow for a meaningful assessment of the performance of the internal rating processes. Banking organizations would further be expected to decompose this to provide analysis of PD, LGD and EAD estimates against estimates provided in the quantitative risk assessment disclosures above.[56]

Disclosures for banking book equity positions would include both balance sheet and fair values, and the types and nature of investments. The total cumulative realized gains or losses arising from sales and liquidations would be disclosed, together with total unrealized gains/losses and any amounts included in Tier 1 and/or Tier 2 capital. Details on the equity capital requirements would also be disclosed.

Disclosures relating to credit risk mitigation would include a description of the policies and processes for netting and collateral valuation and management, and the types of collateral accepted by the bank. Banking organizations would also be expected to include information about the main types of guarantor or credit derivative counterparties, and any risk concentrations arising from the use of a mitigation technique.

Securitization disclosures would summarize a banking organization's accounting policies for securitization activities and the current year's securitization activity. Further, banking organizations would be expected to disclose the names of the external credit rating providers used for securitizations. They would also provide details of the outstanding exposures securitized by the banking organization and subject to the securitization framework, including impairments and losses, exposures retained or purchased broken down into risk weight bands, and aggregate outstanding amounts of securitized revolving exposures.

Disclosures for market risk would include a description of the models, stress testing, and backtesting used in assessing market risk, as well as information on the scope of supervisory acceptance. Quantitative disclosures would include the aggregate VaR, the high, mean, and low VaR values over the reporting period, and a comparison of VaR estimates with actual outcomes.

A key disclosure under the operational risk framework would be a description of the AMA the banking organization uses, including a discussion of relevant internal and external factors considered in the banking organization's measurement approach. In addition, the banking organization would disclose the operational risk charge before and after any reduction in capital resulting from the use of insurance or other potential risk mitigants.

Finally, disclosures relating to interest rate risk in the banking book would include the nature of that risk, key assumptions made, and the frequency of risk measurement. They would also include the increase or decline in earnings or economic value for upward and downward rate shocks according to management's method for measuring interest rate risk in the banking book.

The Agencies seek comment on the feasibility of such an approach to the disclosure of pertinent information and also whether commenters have any other suggestions regarding how best to present the required disclosures.

Comments are requested on whether the Agencies' description of the required formal disclosure policy is adequate, or whether additional guidance would be useful.

Comments are requested regarding whether any of the information sought by the Agencies to be disclosed raises any particular concerns regarding the disclosure of proprietary or confidential information. If a commenter believes certain of the required information would be proprietary or confidential, the Agencies seek comment on why that is so and alternatives that would meet the objectives of the required disclosure.

The Agencies also seek comment regarding the most efficient means for institutions to meet the disclosure requirements. Specifically, the Agencies are interested in comments about the feasibility of requiring institutions to provide all requested information in one location and also whether commenters have other suggestions on how to ensure that the requested information is readily available to market participants.

VII. Regulatory Analysis

Federal agencies are required to consider the costs, benefits, or other effects of their regulations for various purposes described by statute or executive order. In particular, an executive order and several statutes may require the preparation of detailed analyses of the costs, benefits, or other effects of rules, depending on threshold determinations as to whether the rulemaking in question triggers the substantive requirements of the applicable statute or executive order.

For the reasons described above, the proposed and final rules that the Agencies may issue to implement the New Accord would represent a significant change to their current approach to the measurement of regulatory capital ratios, and the supervision of institutions' internal risk management processes with respect to capital allocations. First, in this ANPR, core and opt-in banks would rely on their own analyses to derive some of the principal inputs that would determine their regulatory capital requirements. Core and opt-in banks would incur new costs to create and refine their internal systems and to attract and train the staff expertise necessary to develop, oversee, manage and test those systems. Second, the measured regulatory capital ratios (although not the minimums) would likely change, perhaps substantially for core and opt-in banks. Third, the Agencies' approach to supervising capital adequacy would become bifurcated; that is, general banks would continue to use the general risk-based capital rules, either in their current form or as modified. As a result, there may be significant differences in the regulatory capital assigned to a particular type of asset depending on whether the bank is a core, opt-in, or general bank. To the extent that an institution's product mix would be directly affected by a change in the landscape of regulatory capital requirements, this might also affect the customers of those institutions due to

aggregating internal grades (either PD/LGD or EL) for the purposes of disclosure, this should be a representative breakdown of the distribution of those grades used in the IRB approach.

[55] For banking organizations implementing the A–IRB and AMA in 2007, the disclosures would be required from year-end-2008; in the meantime, early adoption would be encouraged. The phased implementation is to allow banking organizations sufficient time to build up a longer run of data that will make these disclosures meaningful. For banking organizations that may adopt the advanced approaches at a later date, they would also be subject to a one-year phase in period after which the disclosures would be required.

[56] Banking organizations would have to provide this further decomposition where it would allow users greater insight into the reliability of the estimates provided in the quantitative disclosures: risk assessment. In particular, banking organizations should provide this information where there are material differences between the PD, LGD or EAD estimates given by banking organizations compared in actual outcomes over the long run. Banking organizations should also provide explanations for such differences.

the changes in pricing and market strategies.

The economic impact that would be created by these possibly unforeseen competitive effects is difficult to estimate, and the Agencies encourage comment. In particular, the Agencies are interested in comments on the competitive impact that a change in the regulatory capital regime applied to large institutions would have relative to the competitive position of smaller institutions that remain subject to the general risk-based capital rules. Conversely, if the regulatory burden of the more prescriptive A–IRB approach applied to core institutions were so large as to offset the potential for a lower measured capital requirement for certain exposures, then the competitive position of large institutions, with respect to both their domestic and international competitors, might be worsened. The Agencies are also interested in comments that address the competitive position of regulated institutions in the United States with respect to financial service providers, both domestic and foreign, that are not subject to the same degree of regulatory oversight.

None of the Agencies has yet made the threshold determinations required by executive order or statute with respect to this ANPR. Because the proposed approaches to assessing capital adequacy described in this ANPR are new, the Agencies currently lack information that is sufficiently specific or complete to permit those determinations to be made or to prepare any economic analysis that may ultimately be required. Therefore, this section of the ANPR describes the relevant executive order and statutes, and asks for comment and information that will assist in the determination of whether such analyses would be necessary before the Agencies published proposed or final rules.

Quantitative information would be the most useful to the Agencies. However, commenters may also provide estimates of costs, benefits, or other effects, or any other information they believe would be useful to the Agencies in making the determinations. In addition, commenters are asked to identify or estimate start-up, or non-recurring, costs separately from costs or effects they believe would be ongoing.

A. Executive Order 12866

Executive Order 12866 requires preparation of an economic analysis for agency actions that are ''significant regulatory actions.'' ''Significant regulatory actions'' include, among other things, regulations that ''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. * * *''[57] Regulatory actions that satisfy one or more of these criteria are called ''economically significant regulatory actions.'' E.O. 12866 applies to the OCC and the OTS, but not the Board or the FDIC. If the OCC or the OTS determines that the rules implementing the New Accord comprise an ''economically significant regulatory action,'' then the agency making that determination would be required to prepare and submit to the Office of Management and Budget's (OMB) Office of Information and Regulatory Affairs (OIRA) an economic analysis that includes:

- A description of the need for the rules and an explanation of how they will meet the need;
- An assessment of the benefits anticipated from the rules (for example, the promotion of the efficient functioning of the economy and private markets) together with, to the extent feasible, a quantification of those benefits;
- An assessment of the costs anticipated from the rules (for example, the direct cost both to the government in administering the regulation and to businesses and others in complying with the regulation, and any adverse effects on the efficient functioning of the economy, private markets (including productivity, employment, and competitiveness)), together with, to the extent feasible, a quantification of those costs; and
- An assessment of the costs and benefits of potentially effective and reasonably feasible alternatives to the planned regulation (including improving the current regulation and reasonably viable nonregulatory actions), and an explanation why the planned regulatory action is preferable to the identified potential alternatives.[58]

For purposes of determining whether this rulemaking would constitute an ''economically significant regulatory action,'' as defined by E.O. 12866, and to assist any economic analysis that E.O. 12866 may require, the OCC and the OTS encourage commenters to provide information about:

- The direct and indirect costs, for core banks and those banks who intend to qualify as opt-in banks, of compliance with the approach described in this ANPR and the related supervisory guidance;
- The costs, for general banks, of adopting the approach;
- The effects on regulatory capital requirements for core, opt-in, and general banks;
- The effects on competitiveness, in both domestic and international markets, for core, opt-in, and general banks. This would include the possible effects on the customers served by these U.S. institutions through changes in the mix of product offerings and prices;
- The economic benefits of the approach for core, opt-in, or general banks, as measured by lower regulatory capital ratios, and a potentially more efficient allocation of capital. This might also include estimates of savings associated with regulatory capital arbitrage transactions that are currently undertaken in order to optimize return on capital under the current capital regime. That is, what estimates might exist to quantify the improvements in market efficiency from no longer pursuing regulatory capital arbitrage transactions?
- The features of the A–IRB approach that provide an incentive for a bank to seek to qualify to use it, that is, to become an opt-in bank.

The OCC and the OTS also encourage comment on any alternatives to the regulatory approaches described in the ANPR that the Agencies should consider.

B. Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA) generally requires agencies to prepare a ''regulatory flexibility analysis'' unless the head of the agency certifies that a regulation will not ''have a significant economic impact on a substantial number of small entities.''[59] The RFA applies to all of the Agencies.

The Agencies understand that the RFA has been construed to require

[57] Executive Order 12866 (Sept. 30, 1993), 58 FR 51735 (Oct. 4, 1993), as amended by Executive Order 13258, 67 FR 9385 (referred to hereafter as E.O. 12866). For the complete text of the definition of ''significant regulatory action,'' see E.O. 12866 at § 3(f). A ''regulatory action'' is ''any substantive action by an agency (normally published in the Federal Register) that promulgates or is expected to lead to the promulgation of a final rule or regulation, including notices of inquiry, advance notices of proposed rulemaking, and notices of proposed rulemaking.'' E.O. 12866 at § (e).

[58] The components of the economic analysis are set forth in E.O. 12866 § 6(a)(3)(C)(i)–(iii). For a description of the methodology that OMB recommends for preparing an economic analysis, see Office of Management and Budget, ''Economic Analysis of Federal Regulations Under Executive Order 12866'' (January 11, 1996). This publication is available on OMB's Web site at *http://www.whitehouse.gov/omb/inforeg/riaguide.html.* OMB recently published revisions to this publication for comment. *See* 68 FR 5492 (February 3, 2003).

[59] The RFA is codified at 5 U.S.C. 601 *et seq.*

consideration only of the direct impact on small entities.[60] The Small Business Administration (SBA) has said: ''The courts have held that the RFA requires an agency to perform a regulatory flexibility analysis of small entity impacts only when a rule directly regulates them,'' that is, when it directly applies to them.[61] Since the proposed approach would directly apply to only a limited number of large banking organizations, it would appear that the Agencies may certify that the issuance of this ANPR would not have significant economic impact on a substantial number of small entities.

Do the potential advantages of the A–IRB approach, as measured by the specific capital requirements on lower-risk loans, create a competitive inequality for small institutions, which are effectively precluded from adopting the A–IRB due to stringent qualification standards? Conversely, would small institutions that remain on the general risk-based capital rules be at a competitive advantage from specific capital requirements on higher risk assets vis-à-vis advanced approach institutions? How might the Agencies estimate the effect on credit availability to small businesses or retail customers of general banks?

C. Unfunded Mandates Reform Act of 1995

The Unfunded Mandates Reform Act of 1995 (UMRA) requires preparation of a written budgetary impact statement before promulgation of any rule likely to result in a ''Federal mandate'' that ''may result in the expenditure by State, local, and tribal governments, in the aggregate, or by the private sector, of $100,000,000 or more (adjusted annually for inflation) in any 1 year.'' [62] A ''Federal mandate'' includes any regulation ''that would impose an enforceable duty upon the private sector. * * *'' If a budgetary impact statement is required, the UMRA further requires the agency to identify and consider a reasonable number of regulatory alternatives before promulgating the rule in question. The UMRA applies to the OCC and the OTS, but not the Board or the FDIC.

The OCC and the OTS have asked for comments and information from core and opt-in banks on compliance costs and, generally, on alternative regulatory approaches, for purposes of evaluating what actions they need to take in order to comply with E.O. 12866. That same information (with cost information adjusted annually for inflation) is relevant to those agencies' determination of whether a budgetary impact statement is necessary pursuant to the UMRA. Commenters are therefore asked to be mindful of the UMRA requirements when they provide information about compliance costs and in suggesting alternatives to the approach described in this ANPR.

D. Paperwork Reduction Act

Each of the Agencies is subject to the Paperwork Reduction Act of 1995 (PRA).[63] The PRA requires burden estimates that will likely be based on some of the same information that is necessary to prepare an economic analysis under E.O. 12866 or an estimate of private sector expenditures pursuant to the UMRA.

In particular, an agency may not ''conduct or sponsor'' a collection of information without conducting an analysis that includes an estimate of the ''burden'' imposed by the collection. A collection of information includes, essentially, the eliciting of identical information—whether through questions, recordkeeping requirements, or reporting requirements—from ten or more persons. ''Burden'' means the ''time, effort, or financial resources expended by persons to generate, maintain, or provide information'' to the agency. The rulemaking initiated by this ANPR will likely impose requirements, either in the regulations themselves or as part of interagency implementation guidance, that are covered by the PRA. In order to estimate burden, the Agencies will need to know, for example, the cost—in terms of time and money—that mandatory and opt-in banks would have to expend to develop and maintain the systems, procedures, and personnel that compliance with the rules would require. With this in mind, to assist in their analysis of the treatment of retail portfolios and other exposures, the Agencies intend to request from U.S. institutions additional quantitative data for which confidential treatment may be requested in accordance with the Agencies' applicable rules.

While it will be difficult to identify those requirements with precision before a proposed rule is issued, this notice and the draft supervisory guidance published elsewhere in today's **Federal Register** generally describes aspects of the Agencies' implementation of the New Accord where new reporting and recordkeeping requirements would be likely. Commenters are asked to provide any estimates they can reasonably derive about the time, effort, and financial resources that will be required to provide the Agencies with the requisite plans, reports, and records that are described in this notice and in the supervisory guidance. Commenters also are requested to identify any activities that will be conducted as a result from the capital and methodological standards in the framework presented in this ANPR that would impose new recordkeeping or reporting burden. Commenters should specify whether certain capital and methodological standards would necessitate the acquisition or development of new compliance/ information systems or the significant modification of existing compliance/information systems.

List of Acronyms

ABCP Asset-Backed Commercial Paper
ADC Acquisition, Development, and Construction
AFS Available-for-Sale (securities)
AIG Accord Implementation Group
A–IRB Advanced Internal Ratings-Based (approach for credit risk)
ALLL Allowance for Loan and Lease Losses
AMA Advanced Measurement Approach (for operational risk)
ANPR Advance Notice of Proposed Rulemaking
BIS Bank for International Settlements
BSC Basel Committee on Banking Supervision
CCF Credit Conversion Factor
CDC Community Development Corporations
CEDE Community and Economic Development Entity
CF Commodities Finance
CRE Commercial Real Estate
CRM Credit Risk Mitigation
EAD Exposure at Default
EL Expected Loss
FFIEC Federal Financial Institutions Examination Council
FMI Future Margin Income
GAAP Generally Accepted Accounting Principles
HVCRE High Volatility Commercial Real Estate
IMF International Monetary Fund

[60] With respect to banks, the Small Business Administration (SBA) has defined a small entity to be a bank with total assets of $150 million or less. 13 CFR § 121.201.

[61] SBA Office of Advocacy, A Guide for Government Agencies, ''How to Comply with the Regulatory Flexibility Act (May 2003), at 20 (emphasis added). *See also Mid-Tex Electric Cooperative, Inc.* v. *FERC.* 773 F.2d 327, 340–43 (D.C. Cir. 1985) (''[W]e conclude that an agency may properly certify that no regulatory flexibility analysis is necessary when it determines that the rule will not have a significant economic impact on a substantial number of small entities *that are subject to the requirements of the rule.''*) (emphasis added) (construing language in the RFA that was unchanged by subsequent statutory amendments).

[62] The Unfunded Mandates Reform Act is codified at 2 U.S.C. 1532 *et seq.*

[63] 44 U.S.C. § 3501 *et seq.*

IRB Internal Ratings-Based
KIRB Capital for Underlying Pool of Exposures (securitizations)
LGD Loss Given Default
M Maturity
MDB Multilateral Development Bank
OF Object Finance
OTC Over-the-Counter (derivatives)
PCA Prompt Corrective Action (regulation)
PD Probability of Default
PDF Probability Density Function
PF Project Finance
PFE Potential Future Exposure
PMI Private Mortgage Insurance
PRA Paperwork Reduction Act
PSE Public-Sector Entity
QIS3 Third Quantitative Impact Study
QRE Qualifying Revolving Exposures
R Asset Correlation
RBA Ratings-Based Approach (securitizations)
RFA Regulatory Flexibility Act
S Borrower-Size
SBIC Small Business Investment Company
SFA Supervisory Formula Approach (securitizations)
SL Specialized Lending
SME Small-to Medium-Sized Enterprise
SPE Special Purpose Entity
SSC Supervisory Slotting Criteria
UL Unexpected Loss
UMRA Unfunded Mandates Reform Act
VaR Value at Risk (model)

Dated: July 17, 2003.

John D. Hawke, Jr.,

Comptroller of the Currency.

By order of the Board of Governors of the Federal Reserve System, July 21, 2003.

Jennifer J. Johnson,

Secretary of the Board.

Dated at Washington, DC, this 11th day of July, 2003.

By order of the Board of Directors.

Federal Deposit Insurance Corporation.

Robert E. Feldman,

Executive Secretary.

Dated: July 18, 2003.

By the Office of Thrift Supervision.

James E. Gilleran,

Director.

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DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

[Docket No. 03–15]

FEDERAL RESERVE SYSTEM

[Docket No. OP–1153]

FEDERAL DEPOSIT INSURANCE CORPORATION

DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

[No. 2003–28]

Internal Ratings-Based Systems for Corporate Credit and Operational Risk Advanced Measurement Approaches for Regulatory Capital

AGENCIES: Office of the Comptroller of the Currency (OCC), Treasury; Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); and Office of Thrift Supervision (OTS), Treasury.

ACTION: Draft supervisory guidance with request for comment.

SUMMARY: The OCC, Board, FDIC, and OTS (the Agencies) are publishing for industry comment two documents that set forth draft supervisory guidance for implementing proposed revisions to the risk-based capital standards in the United States. These proposed revisions, which would implement the New Basel Capital Accord in the United States, are published as an advance notice of proposed rulemaking (ANPR) elsewhere in today's **Federal Register**. Under the advanced approaches for credit and operational risk described in the ANPR, banking organizations would use internal estimates of certain risk components as key inputs in the determination of their regulatory capital requirements. The Agencies believe that supervisory guidance is necessary to balance the flexibility inherent in the advanced approaches with high standards that promote safety and soundness and encourage comparability across institutions.

The first document sets forth Draft Supervisory Guidance on Internal Ratings-Based Systems for Corporate Credit (corporate IRB guidance). This document describes supervisory expectations for institutions that intend to adopt the advanced internal ratings-based approach (A–IRB) for credit risk as set forth in today's ANPR. The corporate IRB guidance is intended to provide supervisors and institutions with a clear description of the essential components and characteristics of an acceptable A–IRB framework. The guidance focuses specifically on corporate credit portfolios; further guidance is expected at a later date on other credit portfolios (including, for example, retail and commercial real estate portfolios).

The second document sets forth Draft Supervisory Guidance on Operational Risk Advanced Measurement Approaches for Operational Risk (AMA guidance). This document outlines supervisory expectations for institutions that intend to adopt an advanced measurement approach (AMA) for operational risk as set forth in today's ANPR.

The Agencies are seeking comments on the supervisory standards set forth in both documents. In addition to seeking comment on specific aspects of the supervisory guidance set forth in the documents, the Agencies are seeking comment on the extent to which the supervisory guidance strikes the appropriate balance between flexibility and specificity. Likewise, the Agencies are seeking comment on whether an appropriate balance has been struck between the regulatory requirements set forth in the ANPR and the supervisory standards set forth in these documents.

DATES: Comments must be received no later than November 3, 2003.

ADDRESSES: Comments should be directed to:

OCC: Please direct your comments to: Office of the Comptroller of the Currency, 250 E Street, SW., Public Information Room, Mailstop 1–5, Washington, DC 20219, Attention: Docket No. 03–15; fax number (202) 874–4448; or Internet address: *regs.comments@occ.treas.gov.* Due to delays in paper mail delivery in the Washington area, we encourage the submission of comments by fax or e-mail whenever possible. Comments may be inspected and photocopied at the OCC's Public Information Room, 250 E Street, SW., Washington, DC. You may make an appointment to inspect comments by calling (202) 874–5043.

Board: Comments should refer to Docket No. OP–1153 and may be mailed to Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC, 20551. However, because paper mail in the Washington area and at the Board of Governors is subject to delay, please consider submitting your comments by e-mail to *regs.comments@federalreserve.gov*, or faxing them to the Office of the Secretary at 202/452–3819 or 202/452–3102. Members of the public may inspect comments in Room MP–500 of the Martin Building between 9 a.m. and 5 p.m. on weekdays pursuant to § 261.12, except as provided in § 261.14, of the Board's Rules Regarding Availability of Information, 12 CFR 261.12 and 261.14.

FDIC: Written comments should be addressed to Robert E. Feldman, Executive Secretary, Attention: Comments, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC, 20429. Commenters are encouraged to submit comments by facsimile transmission to (202) 898–3838 or by electronic mail to *Comments@FDIC.gov.* Comments also 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 8:30 a.m. and 5 p.m. Comments may be inspected and photocopied at the FDIC's Public Information Center, Room 100, 801 17th Street, NW., Washington, DC between 9 a.m. and 4:30 p.m. on business days.

OTS: Send comments to Regulation Comments, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552, Attention: No. 2003–28. Delivery: Hand deliver comments to the 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: No. 2003–28. Facsimiles: Send facsimile transmissions to FAX Number (202) 906–6518, Attention: No 2003–28. e-mail: Send e-mails to *regs.comments@ots.treas.gov*, Attention: No. 2003–28, and include your name and telephone number. Due to temporary disruptions in mail service in the Washington, DC area, commenters are encouraged to send comments by fax or e-mail, if possible.

FOR FURTHER INFORMATION CONTACT:

OCC: Corporate IRB guidance: Jim Vesely, National Bank Examiner, Large Bank Supervision (202/874–5170 or *james.vesely@occ.treas.gov*); AMA guidance: Tanya Smith, Senior International Advisor, International Banking & Finance (202/874–4735 or *tanya.smith@occ.treas.gov*).

Board: Corporate IRB guidance: David Palmer, Supervisory Financial Analyst, Division of Banking Supervision and Regulation (202/452–2904 or *david.e.palmer@frb.gov*); AMA guidance: T. Kirk Odegard, Supervisory Financial Analyst, Division of Banking Supervision and Regulation (202/530–6225 or *thomas.k.odegard@frb.gov*). For users of Telecommunications Device for the Deaf (''TDD'') only, contact 202/263–4869.

FDIC: Corporate IRB guidance and AMA guidance: Pete D. Hirsch, Basel Project Manager, Division of Supervision and Consumer Protection (202/898–6751 or *phirsch@fdic.gov*).

OTS: Corporate IRB guidance and AMA guidance: Michael D. Solomon, Senior Program Manager for Capital Policy (202/906–5654); David W. Riley, Project Manager (202/906–6669), Supervision Policy; Teresa A. Scott, Counsel (Banking and Finance) (202/906–6478); or Eric Hirschhorn, Principal Financial Economist (202/906–7350), Regulations and Legislation Division, Office of the Chief Counsel, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552.

Document 1: Draft Supervisory Guidance on Internal Ratings-Based Systems for Corporate Credit

Table of Contents

I. Introduction

A. Purpose

This document describes supervisory expectations for banking organizations (institutions) adopting the advanced internal ratings-based approach (IRB) for the determination of minimum regulatory risk-based capital requirements. The focus of this guidance is corporate credit portfolios. Retail, commercial real estate, securitizations, and other portfolios will be the focus of later guidance. This draft guidance should be considered with the advance notice of proposed rulemaking (ANPR) on revisions to the risk-based capital standard published elsewhere in today's **Federal Register**.

The primary objective of IRB is to enhance the sensitivity of regulatory capital requirements to credit risk. To accomplish that objective, IRB harnesses a bank's own risk rating and quantification capabilities. In general, the IRB approach reflects and extends recent developments in risk management and banking supervision. However, the degree to which any individual bank will need to modify its own credit risk management practices to deliver accurate and consistent IRB risk parameters will vary from institution to institution.

This guidance is intended to provide supervisors and institutions with a clear description of the essential components and characteristics of an acceptable IRB framework. Toward that end, this document sets forth IRB system supervisory standards that are highlighted in bold and designated by the prefix ''S.'' Whenever possible, these supervisory standards are principle-based to enable institutions to implement the framework flexibly. However, when prudential concerns or the need for standardization override the desire for flexibility, the supervisory standards are more detailed. Ultimately, institutions must have credit risk management practices that are consistent with the substance and spirit of the standards in this guidance.

The IRB conceptual framework outlined in this document is intended neither to dictate the precise manner by which institutions should seek to meet supervisory expectations, nor to provide technical guidance on how to develop such a framework. As institutions develop their IRB systems in anticipation of adopting them for regulatory capital purposes, supervisors will be evaluating, on an individual bank basis, the extent to which institutions meet the standards outlined in this document. In evaluating institutions, supervisors will rely on this supervisory guidance as well as examination procedures, which will be developed separately. This document assumes that readers are familiar with the proposed IRB approach to calculating minimum regulatory capital articulated in the ANPR.

B. Overview of Supervisory Expectations

Rigorous credit risk measurement is a necessary element of advanced risk management. Qualifying institutions will use their internal rating systems to associate a probability of default (PD) with each obligor grade, as well as a loss given default (LGD) with each credit facility. In addition, institutions will estimate exposure at default (EAD) and will calculate the effective remaining maturity (M) of credit facilities.

Qualifying institutions will be expected to have an IRB system consisting of four interdependent components:

- A system that assigns ratings and validates their accuracy (Chapter 1),
- A quantification process that translates risk ratings into IRB parameters (Chapter 2),
- A data maintenance system that supports the IRB system (Chapter 3), and,

• Oversight and control mechanisms that ensure the system is functioning as intended and producing accurate ratings (Chapter 4).

Together these rating, quantification, data, and oversight mechanisms present a framework for defining and improving the evaluation of credit risk.

It is expected that rating systems will operate dynamically. As ratings are assigned, quantified and used, estimates will be compared with actual results and data will be maintained and updated to support oversight and validation efforts and to better inform future estimates. The rating system review and internal audit functions will serve as control mechanisms that ensure that the process of ratings assignment and quantification function according to policy and design and that noncompliance and weaknesses are identified, communicated to senior management and the board, and addressed. Rating systems with appropriate data and oversight feedback mechanisms foster a learning environment that promotes integrity in the rating system and continuing refinement.

IRB systems need the support and oversight of the board and senior management to ensure that the various components fit together seamlessly and that incentives to make the system rigorous extend across line, risk management, and other control groups. Without strong board and senior management support and involvement, rating systems are unlikely to provide accurate and consistent risk estimates during both good and bad times.

The new regulatory minimum capital requirement is predicated on an institution's internal systems being sufficiently advanced to allow a full and accurate assessment of its risk exposures. Under the new framework, an institution could experience a considerable capital shortfall in the most difficult of times if its risk estimates are materially understated. Consequently, the IRB framework demands a greater level of validation work and controls than supervisors have required in the past. When properly implemented, the new framework holds the potential for better aligning minimum capital requirements with the risk taken, pushing capital requirements higher for institutions that specialize in riskier types of lending, and lower for those that specialize in safer risk exposures.

Supervisors will evaluate compliance with the supervisory standards for each of the four components of an IRB system. However, evaluating compliance with each of the standards individually will not be sufficient to determine an institution's overall compliance. Rather, supervisors and institutions must also evaluate how well the various components of an institution's IRB system complement and reinforce one another to achieve the overall objective of accurate measures of risk. In performing their evaluation, supervisors will need to exercise considerable supervisory judgment, both in evaluating the individual components and the overall IRB framework. A summary of the key supervisory expectations for each of the IRB components follows.

Ratings Assignment

The first component of an IRB system involves the assignment and validation of ratings (see Chapter 1). Ratings must be accurately and consistently applied to all corporate credit exposures and be subject to initial and ongoing validation. Institutions will have latitude in designing and operating IRB rating systems subject to five broad standards:

Two-dimensional risk-rating system—IRB institutions must be able to make meaningful and consistent differentiations among credit exposures along two dimensions—obligor default risk and loss severity in the event of a default.

Rank order risks—IRB institutions must rank obligors by their likelihood of default, and facilities by the loss severity expected in default.

Calibration—IRB obligor ratings must be calibrated to values of the probability of default (PD) parameter and loss severity ratings must be calibrated to values of the loss given default (LGD) parameter.

Accuracy—Actual long-run actual default frequencies for obligor rating grades must closely approximate the PDs assigned to those grades and realized loss rates on loss severity grades must closely approximate the LGDs assigned to those grades.

Validation process—IRB institutions must have ongoing validation processes for rating systems that include the evaluation of developmental evidence, process verification, benchmarking, and the comparison of predicted parameter values to actual outcomes (back-testing).

Quantification

The second component of an IRB system is a quantification process (see Chapter 2). Since obligor and facility ratings may be assigned separately from the quantification of the associated PD and LGD parameters, quantification is addressed as a separate process. The quantification process must produce values not only for PD and LGD but also for EAD and for the effective remaining maturity (M). The quantification of those four parameters is expected to be the result of a disciplined process. The key considerations for effective quantification are as follows:

Process—IRB institutions must have a fully specified process covering all aspects of quantification (reference data, estimation, mapping, and application).

Documentation—The quantification process, including the role and scope of expert judgment, must be fully documented and updated periodically.

Updating—Parameter estimates and related documentation must be updated regularly.

Review—A bank must subject all aspects of the quantification process, including design and implementation, to an appropriate degree of independent review and validation.

Constraints on Judgment—Judgmental adjustments may be an appropriate part of the quantification process, but must not be biased toward lower risk estimates.

Conservatism—Parameter estimates must incorporate a degree of conservatism that is appropriate for the overall robustness of the quantification process.

Data Maintenance

The third component of an IRB system is an advanced data management system that produces credible and reliable risk estimates (see Chapter 3). The broad standard governing an IRB data maintenance system is that it supports the requirements for the other IRB system components, as well as the institution's broader risk management and reporting needs. Institutions will have latitude in managing their data, subject to the following key data maintenance standards:

Life Cycle Tracking—Institutions must collect, maintain, and analyze essential data for obligors and facilities throughout the life and disposition of the credit exposure.

Rating Assignment Data—Institutions must capture all significant quantitative and qualitative factors used to assign the obligor and loss severity rating.

Support of IRB System—Data collected by institutions must be of sufficient depth, scope, and reliability to:

• Validate IRB system processes,
• Validate parameters,
• Refine the IRB system,
• Develop internal parameter estimates,
• Apply improvements historically,
• Calculate capital ratios,
• Produce internal and public reports, and

- Support risk management.

Control and Oversight Mechanisms

The fourth component of an IRB system is comprised of control and oversight mechanisms that ensure that the various components of the IRB system are functioning as intended (see Chapter 4). Given the various uses of internal risk ratings, including their direct link to regulatory capital requirements, there is enormous, sometimes conflicting, pressure on banks' internal rating systems. Control structures are subject to the following broad standards:

Interdependent System of Controls—IRB institutions must implement a system of interdependent controls that include the following elements:

- Independence,
- Transparency,
- Accountability,
- Use of ratings,
- Rating system review,
- Internal audit, and
- Board and senior management oversight.

Checks and Balances—Institutions must combine the various control mechanisms in a way that provides checks and balances for ensuring IRB system integrity.

The system of oversight and controls required for an effective IRB system may operate in various ways within individual institutions. This guidance does not prescribe any particular organizational structure for IRB oversight and control mechanisms. Banks have broad latitude to implement structures that are most effective for their individual circumstances, as long as those structures support and enhance the institution's ability to satisfy the supervisory standards expressed in this document.

C. Scope of Guidance

This draft guidance reflects work performed by supervisors to evaluate and compare current practices at institutions with the concepts and requirements for an IRB framework. For instances in which a range of practice was observable, examples are provided on how certain practices may or may not qualify. However, in many other instances, practices were at such an early stage of development that it was not feasible to describe specific examples. In those cases, requirements tend to be principle-based and without examples. Given that institutions are still in the early stages of developing qualifying IRB systems, it is expected that this guidance will evolve over time to more explicitly take into account new and improving practices.

D. Timing

S. An IRB system must be operating fully at least one year prior to the institution's intended start date for the advanced approach.

As noted in the ANPR, the significant challenge of implementing a fully complying IRB system requires that institutions and supervisors have sufficient time to observe whether the IRB system is delivering risk-based capital figures with a high level of integrity. The ability to observe the institution's ratings architecture, validation, data maintenance and control functions in a fully operating environment prior to implementation will help identify how well the IRB system design functions in practice. This will be particularly important given that in the first year of implementation institutions will not only be subject to the new minimum capital requirements, but will also be disclosing risk-based capital ratios for the public to rely upon in the assessment of the institution's financial health.

II. Ratings for IRB Systems

A. Overview

This chapter describes the design and operation of risk-rating systems that will be acceptable in an internal ratings-based (IRB) framework. Banks will have latitude in designing and operating IRB rating systems, subject to five broad standards:

Two-dimensional risk-rating system—IRB institutions must be able to make meaningful and consistent differentiations among credit exposures along two dimensions—obligor default risk and loss severity in the event of a default.

Rank order risks—IRB institutions must rank obligors by their likelihood of default, and facilities by the loss severity expected in default.

Calibration—IRB obligor ratings must be calibrated to values of the probability of default (PD) parameter and loss severity ratings must be calibrated to values of the loss given default (LGD) parameter.

Accuracy—Actual long-run actual default frequencies for obligor rating grades must closely approximate the PDs assigned to those grades and actual loss rates on loss severity grades must closely approximate the LGDs assigned to those grades.

Validation process—IRB institutions must have ongoing validation processes for rating systems that include the evaluation of developmental evidence, process verification, benchmarking, and the comparison of predicted parameter values to actual outcomes (back-testing).

B. Credit Ratings

In general, a credit rating is a summary indicator of the relative risk on a credit exposure. Credit ratings can take many forms. The most widely known credit ratings are the public agency ratings, which are expressed as letters; bank internal ratings tend to be expressed as whole numbers—for example, 1 through 10. Some rating model outputs are expressed in terms of probability of default or expected default frequency, in which case they may be more than relative measures of risk. Regardless of the form, meaningful credit ratings share two characteristics:

- They group credits to discriminate among possible outcomes.
- They rank the perceived levels of credit risk.

Banks have used credit ratings of various types for a variety of purposes. Some ratings are intended to rank obligors by risk of default and some are intended to rank facilities[1] by expected loss, which incorporates risk of default and loss severity. Bank rating systems that are geared solely to expected loss will need to be amended to meet the two-dimensional requirements of the IRB approach.

Rating Assignment Techniques

Banks use different techniques, such as expert judgment and models, to assign credit risk ratings. For banks using the IRB approach, how ratings are assigned is important because different techniques will require different validation processes and control mechanisms to ensure the integrity of the rating system. To assist the discussion of rating architecture requirements, described below are some of the current rating assignment techniques. Any of these techniques—expert judgment, models, constrained judgment, or a combination thereof—could be acceptable within an IRB system, provided the bank meets the standards outlined in this document.

Expert Judgment

Historically, banks have used expert judgment to assign ratings to commercial credits. With this technique, an individual weighs relevant information and reaches a conclusion about the appropriate risk rating. Presumably, the rater makes informed judgments based on knowledge gained through experience and training.

[1] Facilities—loans, lines, or other separate extensions of credit to an obligor.

The key feature of expert-judgment systems is flexibility. The prevalence of judgmental rating systems reflects the view that the determinants of default are too complicated to be captured by a single quantitative model. The quality of management is often cited as an example of a risk determinant that is difficult to assess through a quantitative model. In order to foster internal consistency, banks employing expert judgment rating systems typically provide narrative guidelines that set out ratings criteria. However, the expert must decide how narrative guidelines apply to a given set of circumstances.

The flexibility possible in the assignment of judgmental ratings has implications for the types of ratings review that are feasible. As part of the ratings validation process, banks will attempt to confirm that raters follow bank policy. However, two individuals exercising judgment can use the same information to support different ratings. Thus, the review of an expert judgment rating system will require an expert who can identify the impact of policy and the impact of judgment on a rating.

Models

In recent years, models have been developed for use in rating commercial credits. In a model-based approach, inputs are numeric and provide quantitative and qualitative information about an obligor. The inputs are combined using mathematical equations to produce a number that is translated into a categorical rating. An important feature of models is that the rating is perfectly replicable by another party, given the same inputs.

The models used in credit rating can be distinguished by the techniques used to develop them. Some models may rely on statistical techniques while others rely on expert-judgment techniques.

Statistical models. Statistically developed models are the result of statistical optimization, in which well-defined mathematical criteria are used to choose the model that has the closest fit to the observed data. Numerous techniques can be used to build statistical models; regression is one widely recognized example. Regardless of the specific statistical technique, a knowledgeable independent reviewer will have to exercise judgment in evaluating the reasonableness of a model's development, including its underlying logic, the techniques used to handle the data, and the statistical model building techniques.

Expert-derived models.[2] Several banks have built rating models by asking their experts to decide what weights to assign to critical variables in the models. Drawing on their experience, the experts first identify the observable variables that affect the likelihood of default. They then reach agreement on the weights to be assigned to each of the variables. Unlike statistical optimization, the experts are not necessarily using clear, consistent criteria to select the weights attached to the variables. Indeed, expert-judgment model building is often a practical choice when there is not enough data to support a statistical model building. Despite its dependence on expert judgment, this method can be called model-based as long as the result—the equation, most likely with linear weights—is used as the basis to rate the credits. Once the equation is set, the model shares the feature of replicability with statistically derived models. Generally, independent credit experts use judgment to evaluate the reasonableness of the development of these models.

Constrained Judgment

The alternatives just described present the extremes, but in practice, many banks use rating systems that combine models with judgment. Two approaches are common.

Judgmental systems with quantitative guidelines or model results as inputs. Historically, the most common approach to rating has involved individuals exercising judgment about risks, subject to policy guidelines containing quantitative criteria such as minimum values for particular financial ratios. Banks develop quantitative criteria to guide individuals in assigning ratings, but often believe that those criteria do not adequately reflect the information needed to assign a rating.

One version of this constrained judgment approach features a model output as one among several criteria that an individual may consider in assigning ratings. The individual assigning the rating is responsible for prioritizing the criteria, reconciling conflicts between criteria, and if warranted, overriding some criteria. Even if individuals incorporate model results as one of the factors in their ratings, they will exercise judgment in deciding what weight to attach to the model result. The appeal of this approach is that the model combines many pieces of information into a single output, which simplifies analysis, while the rater retains flexibility regarding the use of the model output.

Model-based ratings with judgmental overrides. When banks use rating models, individuals are generally permitted to override the results under certain conditions and within tolerance levels for frequency. Credit-rating systems in which individuals can override models raise many of the same issues presented separately by pure judgment and model-based systems. If overrides are rare, the system can be evaluated largely as if it is a model-based system. If, however, overrides are prevalent, the system will be evaluated more like a judgmental system.

Since constrained judgment systems combine features of both expert judgment and model-based systems, their evaluation will require the skills required to evaluate both of these other systems.

C. IRB Ratings System Architecture

Two-Dimensional Rating System

S. IRB risk rating systems must have two rating dimensions—obligor and loss severity ratings.

S. IRB obligor and loss severity ratings must be calibrated to values of the probability of default (PD) and the loss given default (LGD), respectively.

Regardless of the type of rating system(s) used by an institution, the IRB approach imposes some specific requirements. The first requirement is that an IRB rating system must be two-dimensional. Banks will assign obligor ratings, which will be associated with a PD. They will also either assign a loss severity rating, which will be associated with LGD values, or directly assign LGD values to each facility. The process of assigning the obligor and loss severity ratings—hereafter referred to as the rating system—is discussed below, and the process of calibrating obligor and loss severity ratings to PD and LGD parameters is discussed in Chapter 2.

S. Banks must record obligor defaults in accordance with the IRB definition of default.

Definition of Default

The consistent identification of defaults is fundamental to any IRB rating system. For IRB purposes, a default is considered to have occurred with regard to a particular obligor when either or both of the two following events have taken place:

• The obligor is past due more than 90 days on any material credit

[2] Some banks have developed credit rating models that they refer to as "scorecards," but they have used expert judgment to derive the weights. While they are models, they are not scoring models in the now conventional use of the term. In its conventional use, the term scoring model is reserved for a rating model derived using statistical techniques.

obligation to the banking group. Overdrafts will be considered as being past due once the customer has breached an advised limit or been advised of a limit smaller than current outstandings.

• The bank considers that the obligor is unlikely to pay its credit obligations to the banking group in full, without recourse by the bank to actions such as liquidating collateral (if held).

Any obligor (or its underlying credit facilities) that meets one or more of the following conditions is considered unlikely to pay and therefore in default:

• The bank puts the credit obligation on non-accrual status.

• The bank makes a charge-off or account-specific provision resulting from a significant perceived decline in credit quality subsequent to the bank taking on the exposure.

• The bank sells the credit obligation at a material credit-related economic loss.

• The bank consents to a distressed restructuring of the credit obligation where this is likely to result in a diminished financial obligation caused by the material forgiveness, or postponement, of principal, interest or (where relevant) fees.

• The bank has filed for the obligor's bankruptcy or a similar order in respect of the obligor's credit obligation to the banking group.

• The obligor has sought or has been placed in bankruptcy or similar protection where this would avoid or delay repayment of the credit obligation to the banking group.

While most conditions of default currently are identified by bank reporting systems, institutions will need to augment data capture systems to collect those default circumstances that may not have been traditionally identified. These include facilities that are current and still accruing but where the obligor declared or was placed in bankruptcy. They must also capture so called ''silent defaults''—defaults when the loss on a facility was avoided by liquidating collateral.

Loan sales on which a bank experiences a material loss due to credit deterioration are considered a default. Material credit related losses are defined as XX. (The agencies seek comment on how to define ''material'' loss in the case of loans sold at a discount). Banks should ensure that they have adequate systems to identify such transactions and to maintain adequate records so that reviewers can assess the adequacy of the institution's decision-making process in this area.

Obligor Ratings

S. Banks must assign discrete obligor grades.

While banks may use models to estimate probabilities of default for individual obligors, the IRB approach requires banks to group the obligors into discrete grades. Each obligor grade, in turn, must be associated with a single PD.

S. The obligor-rating system must result in a ranking of obligors by likelihood of default.

The proper operation of the obligor-rating system will feature a ranking of obligors by likelihood of default. For example, if a bank uses a rating system based on a 10-point scale, with 1 representing obligors of highest financial strength and 10 representing defaulted obligors, grades 2 through 9 should represent groups of ever-increasing risk. In a rating system in which risk increases with the grade, an obligor with a grade 4 is riskier than an obligor with a grade 2, but need not be twice as risky.

S. Separate exposures to the same obligor must be assigned to the same obligor rating grade.

As noted above, the IRB framework requires that the obligor rating be distinct from the loss severity rating, which is assigned to the facility. Collateral and other facility characteristics should not influence the obligor rating. For example, in a 1-to-10 rating system, where risk increases with the number grade, a defaulted borrower with a fully cash-secured transaction should be rated a 10—defaulted—regardless of the remote expectation of loss. Likewise, a borrower whose financial condition warrants the highest investment grade rating should be rated a 1 even if the bank's transactions are subordinate to other creditors and unsecured. Since the rating is assigned to the obligor and not the facility, separate exposures to the same obligor must be assigned to the same obligor rating grade.

At the bottom of any IRB system rating scale is a default grade. Once an obligor is considered to be in default for IRB purposes, that obligor must be assigned a default grade until such time as its financial condition and performance improve sufficiently to clearly meet the bank's internal rating definition for one of its non-default grades. Once an obligor is in default on any material credit obligation to the subject bank, all of its facilities at that institution are considered to be in default.

S. In assigning an obligor to a rating category, the bank must assess the risk of obligor default over a period of at least one year.

S. Obligor ratings must reflect the impact of financial distress.

In assigning an obligor to a rating category, the bank must assess the risk of obligor default over a period of at least one year. This use of a one-year assessment horizon does not mean that a bank should limit its consideration to outcomes for that obligor that are most likely over that year; the rating must take into account possible adverse events that might increase an obligor's likelihood of default.

Rating Philosophy—Decisions Underlying Ratings Architecture

S. Banks must adopt a ratings philosophy. Policy guidelines should describe the ratings philosophy, particularly how quickly ratings are expected to migrate in response to economic cycles.

S. A bank's capital management policy must be consistent with its ratings philosophy in order to avoid capital shortfalls in times of systematic economic stress.

In the IRB framework, banks assign obligors to groups that are expected to share common default frequencies. That general description, however, still leaves open different possible implementations, depending on how the bank defines the set of possible adverse events that the obligor might face. A bank must decide whether obligors are grouped by expected common default frequency over the next year (a so-called point-in-time rating system) or by an expected common default frequency over a wider range of possible stress outcomes (a so-called through-the-cycle rating system). Choosing between a point-in-time system and a through-the-cycle system yields a rating philosophy.

In point in time rating systems, obligors are assigned to groups that are expected to share a common default frequency in a particular year. Point-in-time ratings change from year to year as borrowers' circumstances change, including changes due to the economic possibilities faced by the borrowers. Since the economic circumstances of many borrowers reflect the common impact of the general economic environment, the transitions in point-in-time ratings will reflect that systematic influence. A Merton-style probability of default prediction model is commonly believed to be an example of a point-in-time approach to rating (although that may depend on the specific implementation of the model).

Through-the-cycle rating systems do not ask the question, what is the probability of default over the next year.

Instead, they assign obligors to groups that would be expected to share a common default frequency if the borrowers in them were to experience distress, regardless of whether that distress is in the next year. Thus, as the descriptive title suggests, this rating philosophy abstracts from the near-term economic possibilities and considers a richer assessment of the possibilities. Like point-in-time ratings, through the cycle ratings will change from year to year due to changes in borrower circumstance. However, since this rating philosophy abstracts from the immediate economic circumstance and considers the implications of hypothetical stress circumstances, year to year transitions in ratings will be less influenced by changes in the actual economic environment. The ratings agencies are commonly believed to use through-the-cycle rating approaches.

Current practice in many banks in the U.S. is to rate obligors using an approach that combines aspects of both point-in-time and through the cycle approaches. The explanation provided by banks that combine those approaches is that they want rating transitions to reflect the directional impact of changes in the economic environment, but that they do not want all of the volatility in ratings associated with a point-in-time approach.

Regardless of which ratings philosophy a bank chooses, an IRB bank must articulate clearly its approach and the implications of that choice. As part of the choice of rating philosophy, the bank must decide whether the same ratings philosophy will be employed for all of the bank's portfolios. And management must articulate the implications that the bank's ratings philosophy has on the bank's capital planning process. If a bank chooses a ratings philosophy that is likely to result in ratings transitions that reflect the impact of the economic cycle, its capital management policy must be designed to avoid capital shortfalls in times of systematic economic stress.

Obligor-Rating Granularity

S. An institution must have at least seven obligor grades that contain only non-defaulted borrowers and at least one grade to which only defaulted borrowers are assigned.

The number of grades used in a rating system should be sufficient to reasonably ensure that management can meaningfully differentiate risk in the portfolio, without being so large that it limits the practical use of the rating system. To determine the appropriate number of grades beyond the minimum seven non-default grades, each institution must perform its own internal analysis.

S. An institution must justify the number of obligor grades used in its rating system and the distribution of obligors across those grades.

The mere existence of an exposure concentration in a grade (or grades) does not, by itself, reflect weakness in a rating system. For example, banks may focus on a particular type of lending, such as asset-based lending, in which the borrowers may have similar default risk. Banks with such focused lending activities may use close to the minimum number of obligor grades, while banks with a broad range of lending activities should have more grades. However, banks with a high concentration of obligors in a particular grade are expected to perform a thorough analysis that supports such a concentration.

A significant concentration within an obligor grade may be suspected if the financial strength of the borrowers within that grade varies considerably. If obligors seem unduly concentrated, then management should ask themselves the following questions:

- Are the criteria for each grade clear? Those rating criteria may be too vague to allow raters to make clear distinctions. Ambiguity may be an issue throughout the rating scale or it may be limited to the most commonly used ratings.
- How diverse are the obligors? That is how many market segments (for example, large commercial, middle market, private banking, small business, geography, etc.) are significantly represented in the bank's borrower population? If a bank's commercial loan portfolio is not concentrated in one market segment, its risk rating distribution is not likely to be concentrated.
- How broad are the bank's internal rating categories compared to those of other lenders? The bank may be able to learn enough from publicly available information to adjust its rating criteria.

Some banks use ''modifiers'' to provide more risk differentiation to a given rating system. A risk rating modified with a plus, minus or other indicator does not constitute a separate grade unless the bank has developed a distinct rating definition and criteria for the modified grade. In the absence of such distinctions, grades such as 5, 5+, and 5− are viewed as a single grade for regulatory capital purposes regardless of the existence of the modifiers.

Loss Severity Ratings

S. Banks must rank facilities by the expected severity of the loss upon default.

The second dimension of an IRB system is the loss severity rating, which is calibrated to LGD. A facility's LGD estimate is the loss the bank is likely to incur in the event that the obligor defaults, and is expressed as a percentage of exposure at the time of default. LGD estimates can be assigned either through the use of a loss severity rating system or they can be directly assigned to each facility.

LGD analysis is still in very early stages of development relative to default risk modeling. Academic research in this area is relatively sparse, data are not abundant, and industry practice is still widely varying and evolving. Given the lack of data and the lack of research into LGD modeling, some banks are likely, as a first step, to segment their portfolios by a handful of available characteristics and determine the appropriate LGDs for those segments. Over time, banks' LGD methodologies are expected to evolve. Long-standing banking experience and existing research on LGD, while preliminary, suggests that collateral values, seniority, industry, etc. are predictive of loss severity.

S. Banks must have empirical support for LGD rating systems regardless of whether they use an LGD grading system or directly assign LGD estimates.

Whether a bank chooses to assign LGD values directly or, alternatively, to rate facilities and then quantify the LGD for the rating grades, the key requirement is that it will need to identify facility characteristics that influence LGD. Each of the loss severity rating categories must be associated with an empirically supported LGD estimate. In much the same way an obligor-rating system ranks exposures by the probability of default, a facility rating system must rank facilities by the likely loss severity.

Regardless of the method used to assign LGDs (loss severity grades or direct LGD estimation), data used to support the methodology must be gathered systematically. For many banks, the quality and quantity of data available to support the LGD estimation process will have an influence on the method they choose.

Stress Condition LGDs

S. Loss severity ratings must reflect losses expected during periods with a relatively high number of defaults.

Like obligor ratings, which group obligors by expected default frequency, loss severity ratings assign facilities to groups that are expected to experience a common loss severity. However, the different treatment accorded to PD and LGD in the model used to calculate IRB capital requirements mandates an asymmetric treatment of obligor and loss severity ratings. Obligor ratings assign obligors to groups that are expected to experience common default frequencies across a number of years, some of which are years of general economic stress and some of which are not. In contrast, loss severity ratings (or estimates) must pertain to losses expected during periods with a high number of defaults—particular years that can be called stress conditions. For cases in which loss severities do not have a material degree of cyclical variability, use of a long-run default weighted average is appropriate, although stress condition LGD generally exceeds these averages.

Loss Severity Rating/LGD Granularity

S. Banks must have a sufficiently fine loss severity grading system or prediction model to avoid grouping facilities with widely varying LGDs together.

While there is no stated minimum number of loss severity grades, the systems that provide LGD estimates must be flexible enough to adequately segment facilities with significantly varying LGDs. Banks should have a sufficiently fine LGD grading system or LGD prediction model to avoid grouping facilities with widely varying LGDs together. For example, a bank using a loss severity rating-scale approach that has credit products with a variety of collateral packages or financing structures would be expected to have more LGD grades than those institutions with fewer options in their credit products.

Other Considerations of IRB Rating System Architecture

Timeliness of Ratings

S. All risk ratings must be updated whenever new relevant information is received, but must be updated at least annually.

A bank must have a policy that requires a dynamic ratings approach ensuring that obligor and loss severity ratings reflect current information. That policy must also specify minimum financial reporting and collateral valuation requirements. For example, at the time of servicing events, banks typically receive updated financial information on obligors. For cases in which loss severity grades or estimates are dependent on collateral values or other factors that change periodically, that policy must take into account the need to update these factors.

Banks' policies may include an alternative rating update timetable for exposures below a *de minimus* amount that is justified by the lack of materiality of the potential impact on capital. For example, some banks use triggering events to prompt an update of their ratings on *de minimus* exposures rather than adhering to a specific timetable.

Multiple Ratings Systems

Some banks may develop one risk-rating system that can be used across the entire commercial loan portfolio. However, a bank can choose to deploy any number of rating systems as long as all exposures are assigned PD and LGD values. A different rating system could be used for each business line and each rating system could use a different rating scale. A bank could also use a different rating system for each business line with each system using a common rating scale. Rating models could be used for some portfolios and expert judgment systems for others. An institution's complexity and sophistication, as well as the size and range of products offered, will affect the types and numbers of rating systems employed.

While using a number of rating systems is feasible, such a practice might make it more difficult to meet supervisory standards. Each rating system must conform to the standards in this guidance and must be validated for accuracy and consistency. The requirement that each rating systems be calibrated to parameter values imposes the ultimate constraint, which is that ratings be applied consistently.

Recognition of the Risk Mitigation Benefits of Guarantees

S. Banks reflecting the risk-mitigating effect of guarantees must do so by either adjusting PDs or LGDs, but not both.

S. To recognize the risk-mitigating effects of guarantees, institutions must ensure that the written guarantee is evidenced by an unconditional and legally enforceable commitment to pay that remains in force until the debt is satisfied in full.

Adjustments for guarantees must be made in accordance with specific criteria contained in the bank's credit policy. The criteria should be plausible and intuitive, and should address the guarantor's ability and willingness to meet its obligations. Banks are expected to gather evidence that confirms the risk-mitigating effect of guarantees.

Other forms of written third-party support (for example, comfort letters or letters of awareness) that are not legally binding should not be used to adjust PD or LGD unless a bank can demonstrate through analysis of internal data the risk-mitigating effect of such support. Banks may not adjust PDs or LGDs to reflect implied support or verbal assurances.

Regardless of the method used to recognize the risk-mitigating effects of guarantees, a bank must adopt an approach that is applied consistently over time and across the portfolio. Moreover, the onus is on the bank to demonstrate that its approach is supported by logic and empirical results. While guarantees may provide grounds for adjusting PD or LGD, they cannot result in a lower risk weight than that assigned to a similar direct obligation of the guarantor.[3]

Validation Process

S. IRB rating system architecture must be designed to ensure rating system accuracy.

As part of their IRB rating system architecture, banks must implement a process to ensure the accuracy of their rating systems. Rating system accuracy is defined as the combination of the following outcomes:

- The actual long-run average default frequency for each rating grade is not significantly greater than the PD assigned to that grade.
- The actual stress-condition loss rates experienced on defaulted facilities are not significantly greater than the LGD estimates assigned to those facilities.

Some differences across individual grades between observed outcomes and the estimated parameter inputs to the IRB equations can be expected. But if systematic differences suggest a bias toward lowering regulatory capital requirements, the integrity of the rating system (of either the PD or LGD dimensions or of both) becomes suspect. Validation is the set of activities designed to give the greatest possible assurances of ratings system accuracy.

S. Banks must have ongoing validation processes that include the review of developmental evidence, ongoing monitoring, and the comparison of predicted parameter values to actual outcomes (back-testing).

Validation is an integral part of the rating system architecture. Banks must have processes designed to give

[3] The probability that an obligor and a guarantor (who supports the obligor's debt) will both default on a debt is lower than the probability that either the obligor or the guarantor will default. This favorable risk-mitigation effect is known as the reduced likelihood of "double default." In determining their rating criteria and procedures, banks are not permitted to consider possible favorable effects of imperfect expected correlation between default events for the borrower and guarantor for purposes of regulatory capital requirements. Thus, the adjusted risk weight cannot reflect the risk mitigation of double default. The ANPR solicits public comment on the double-default issues.

reasonable assurances of their rating systems' accuracy. The ongoing process to confirm and ensure rating system accuracy consists of:

- The evaluation of developmental evidence,
- Ongoing monitoring of system implementation and reasonableness (verification and benchmarking), and
- Back-testing (comparing actual to predicted outcomes).

IRB institutions are expected to employ all of the components of this process. However, the data to perform comprehensive back-testing will not be available in the early stages of implementing an IRB rating system. Therefore, banks will have to rely more heavily on developmental evidence, quality control tests, and benchmarking to assure themselves and other interested parties that their rating systems are likely to be accurate. Since the time delay before rating systems can be back-tested is likely to be an important issue—because of the rarity of defaults in most years and the bunching of defaults in a few years—the other parts of the validation process will assume greater importance. If rating processes are developed in a learning environment in which banks attempt to change and improve ratings, back testing may be delayed even further. Validation in its early stages will depend on bank management's exercising informed judgment about the likelihood of the rating system working—not simply on empirical tests.

Ratings System Developmental Evidence

The first source of support for the validity of a bank's rating system is developmental evidence. Evaluating developmental evidence involves making a reasonable assessment of the quality of the rating system by analyzing its design and construction. Developmental evidence is intended to answer the question, Could the rating system be expected to work reasonably if it is implemented as designed? That evidence will have to be revisited whenever the bank makes a change to its rating system. If a bank adopts a rating system and does not make changes, this step will not have to be revisited. However, since rating systems are likely to change over time as the bank learns about the effectiveness of the system and incorporates the results of those analyses, the evaluation of developmental evidence is likely to be an ongoing part of the process. The particular steps taken in evaluating developmental evidence will depend on the type of rating system.

Generally, the evaluation of developmental evidence will include a body of expert opinion. For example, developmental evidence in support of a statistical rating model must include information on the logic that supports the model and an analysis of the statistical model-building techniques. In contrast, developmental evidence in support of a constrained-judgment system that features guidance values of financial ratios might include a description of the logic and evidence relating the values of the ratios to past default and loss outcomes.

Regardless of the type of rating system, the developmental evidence will be more persuasive when it includes empirical evidence on how well the ratings might have worked in the past. This evidence should be available for a statistical model since such models are chosen to maximize the fit to outcomes in the development sample. In addition, statistical models should be supported by evidence that they work well outside the development sample. Use of ''holdout'' sample evidence is a good model-building practice to ensure that the model is not merely a statistical quirk of the particular data set used to build the model.

Empirical developmental evidence of rating effectiveness will be more difficult to produce for a judgmental rating system. Such evidence would require asking raters how they would have rated past credits for which they did not know the outcomes. Those retrospective ratings could then be compared to the outcomes to determine whether the ratings were correct on average. Conducting such tests, however, will be difficult because historical data sets may not include all of the information that an individual would have actually used in making a judgment about a rating.

The sufficiency of the developmental evidence will itself be a matter of informed expert opinion. Even if the rating system is model-based, an evaluation of developmental evidence will entail judging the merits of the model-building technique. Although no bright line tests are feasible because expert judgment is essential to the evaluation of rating system development, experts will be able to draw conclusions about whether a well-implemented system would be likely to perform satisfactorily.

Ratings System Ongoing Validation

The second source of analytical support for the validity of a bank rating system is the ongoing analysis intended to confirm that the rating system is being implemented and continues to perform as intended. Such analysis involves process verification and benchmarking.

Process Verification

Verification activities address the question, Are the ratings being assigned as intended? Specific verification activities will depend on the rating approach. If a model is used for rating, verification analysis begins by confirming that the computer code used to deploy the model is correct. The computer code can be verified in a number of established ways. For example, a qualified expert can duplicate the code or check the code line by line. Process verification for a model will also include confirmation that the correct data are being used in the model.

For expert-judgment and constrained-judgment systems, verification requires other individual reviewers to evaluate whether the rater followed rating policy. The primary requirements for verification of ratings assigned by individuals are:

- A transparent rating process,
- A database with information used by the rater, and
- Documentation of how the decisions were made.

The specific steps will depend on how much the process incorporates specific guidelines and how much the exercise of judgment is allowed. As the dependence on specific guidelines increases, other individuals can more easily confirm that guidelines were followed by reference to sufficient documentation. As the dependence on judgment rises, the ratings review function will have to be staffed increasingly by experts with appropriate skills and knowledge about the rating policies of the bank.

Ratings process verification also includes override monitoring. If individuals have the ability to override either models or policies in a constrained-judgment system, the bank should have both a policy stating the tolerance for overrides and a monitoring system for identifying the occurrence of overrides. A reporting system capturing data on reasons for overrides will facilitate learning about whether overrides improve accuracy.

Benchmarking

S. Banks must benchmark their internal ratings against internal, market and other third-party ratings.

Benchmarking is the set of activities that uses alternative tools to draw inferences about the correctness of ratings before outcomes are actually known. The most important type of benchmarking of a rating system is to ask whether another rater or rating method attaches the same rating to a particular obligor or facility. Regardless of the rating approach, the benchmark can be either a judgmental or a model-based rating. Examples of such benchmarking include:

• Ratings reviewers who completely re-rate a sample of credits rated by individuals in a judgmental system.

• An internally developed model is used to rate credits rated earlier in a judgmental system.

• Individuals rate a sample of credits rated by a model.

• Internal ratings are compared against results from external agencies or external models.

Because it will take considerable time before outcomes will be available, using alternative ratings as benchmarks will be a very important validation device. Such benchmarking must be applied to all rating approaches, and the benchmark can be either a model or judgment. At a minimum, banks must establish a process in which a representative sample of its internal ratings is compared to third-party ratings (*e.g.*, independent internal raters, external rating agencies, models, or other market data sources) of the same credits.

Benchmarking also includes activities designed to draw broader inferences about whether the rating system—as opposed to individual ratings—is working as expected. The bank can look for consistency in ranking or consistency in the values of rating characteristics for similarly rated credits. Examples of such benchmarking activities include:

• Analyzing the characteristics of obligors that have received common ratings.

• Monitoring changes in the distribution of ratings over time.

• Calculating a transition matrix calculated from changes in ratings in a bank's portfolio and comparing it to historical transition matrices from internal bank data or publicly available ratings.

While benchmarking activities allow for inferences about the correctness of the ratings system, they are the not same thing as back-testing. The benchmark itself is a prediction and may be in error. If benchmarking evidence suggests a pattern of rating differences, it should lead the bank to investigate the source of the differences. Thus, the benchmarking process illustrates the possibility of feedback from ongoing validation to model development, underscoring the characterization of validation as a process.

Back Testing

S. Banks must develop statistical tests to back-test their IRB rating systems.

S. Banks must establish internal tolerance limits for differences between expected and actual outcomes.

S. Banks must have a policy that requires remedial actions be taken when policy tolerances are exceeded.

The third component of a validation process is back-testing, which is the comparison of predictions with actual outcomes. Back-testing of IRB systems is the empirical test of the accuracy of the parameter values, PD and LGD, associated with obligor and loss severity ratings, respectively. For IRB rating systems, back-testing addresses the combined effectiveness of the assignment of obligor and loss severity ratings and the calibration of the parameters PD and LGD attached to those ratings.

At this time, there is no generally agreed-upon statistical test of the accuracy of IRB systems. Banks must develop statistical tests to back-test their IRB rating systems. In addition, banks must have a policy that specifies internal tolerance limits for comparing back-testing results. Importantly, that policy must outline the actions that would be taken whenever policy limits are exceeded.

As a combined test of ratings effectiveness, back-testing is a conceptual bridge between the ratings system architecture discussed in this chapter and the quantification of parameters, discussed in Chapter 2. The final section of Chapter 2 discusses back-testing as one type of quantitative test required to validate the quantification of parameter values.

III. Quantification of IRB Systems

Ratings quantification is the process of assigning numerical values to the four key components for internal ratings-based assessments of credit-risk capital: probability of default (PD), the expected loss given default (LGD), the expected exposure at default (EAD), and maturity (M). Section I establishes an organizing framework for considering IRB quantification and develops general principles that apply to the entire process. Sections II through IV cover specific principles or supervisory standards that apply to PD, LGD, and EAD respectively. The maturity component, which is much less dependent on statistical estimates and the use of data, receives somewhat different treatment in section V. Validation of the quantification process is covered in section VI.

A. Introduction

Stages of the Quantification Process

With the exception of maturity, the risk components are unobservable and must be estimated. The estimation must be consistent with sound practice and supervisory standards. In addition, a bank must have processes to ensure that these estimates remain valid.

Calculation of risk components for IRB involves two sets of data: the bank's actual portfolio data, consisting of current credit exposures assigned to internal grades, and a "reference data set," consisting of a set of defaulted credits (in the case of LGD and EAD estimation) or both defaulted and non-defaulted credits (in the case of PD estimation). The bank estimates a relationship between the reference data set and probability of default, loss severity, or exposure; then this estimated relationship is applied to the actual portfolio data for which capital is being assessed.

Quantification proceeds through four logical stages: obtaining reference data; estimating the reference data's relationship to the parameters; mapping the correspondence between the reference data and the portfolio's data; and applying the relationship between reference data and parameters to the portfolio's data. (Readers may find it helpful to refer to the appendix to this chapter, which illustrates how this four-stage framework can be applied to ratings quantification approaches in practice.) An evaluation of any bank's IRB quantification process focuses on understanding how the bank implements each stage for each of the key parameters, and on assessing the adequacy of the bank's approach.

Data—First, the bank constructs a reference data set, or source of data, from which parameters can be estimated.

Reference data sets include internal data, external data, and pooled internal/external data. Important considerations include the comparability of the reference data to the current credit portfolio, whether the sample period "appropriately" includes periods of stress, and the definition of default used in the reference data. The reference data must be described using a set of observed characteristics; consequently, the data set must contain variables that can be used for this characterization. Relevant characteristics might include external debt ratings, financial measures, geographic regions, or any other factors that are believed to be related in some way to PD, LGD, or EAD. More than one reference data set may be used.

Estimation—Second, the bank applies statistical techniques to the reference data to determine a relationship between characteristics of the reference data and the parameters (PD, LGD, or EAD).

The result of this step is a model that ties descriptive characteristics of the obligor or facility in the reference data set to PD, LGD, or EAD estimates. In this context, the term 'models' is used in the most general sense; a model may be simple, such as the calculation of averages, or more complicated, such as an approach based on advanced regression techniques. This step may include adjustments for differences between the IRB definition of default and the default definition in the reference data set, or adjustments for data limitations. More than one estimation technique may be used to generate estimates of the risk components, especially if there are multiple sets of reference data or multiple sample periods.

Mapping—Third, the bank creates a link between its portfolio data and the reference data based on common characteristics.

Variables or characteristics that are available for the current portfolio must be mapped to the variables used in the default, loss-severity, or exposure model. (In some cases, the bank constructs the link for a representative exposure in each internal grade, and the mapping is then applied to all credits within a grade.) An important element of mapping is making adjustments for differences between reference data sets and the bank's portfolio. The bank must create a mapping for each reference data set and for each combination of variables used in any estimation model.

Application—Fourth, the bank applies the relationship estimated for the reference data to the actual portfolio data.

The ultimate aim of quantification is to attribute a PD, LGD, or EAD to each exposure within the portfolio, or to each internal grade if the mapping was done at the grade level. This step may include adjustments to default frequencies or loss rates to ''smooth'' the final parameter estimates. If the estimates are applied to individual transactions, the bank must in some way aggregate the estimates at the grade level. In addition, if multiple data sets or estimation methods are used, the bank must adopt a means of combining the various estimates.

A number of examples are given in this chapter to aid exposition and interpretation. None of the examples is sufficiently detailed to incorporate all the considerations discussed in this chapter. Moreover, technical progress in the area of quantification is rapid. Thus, banks should not interpret an example that is consistent with the standard being discussed, and that resembles the bank's current practice, as creation of a ''safe harbor'' or as an indication that the bank's practice will be approved as-is. Banks should consider this guidance in its entirety when determining whether systems and practices are adequate.

General Principles for Sound IRB Quantification

Several core principles apply to all elements of the overall ratings quantification process; those general principles are discussed in this introductory section. Each of these principles is, in effect, a supervisory standard for IRB systems. Other supervisory standards, specific to particular elements or parameters, are discussed in the relevant sections.

Supervisory evaluation of IRB quantification requires consideration of all of these principles and standards, both general and specific. Particular practical approaches to ratings quantification may be highly consistent with some standards, and less so with others. In any particular case, an ultimate assessment relies on the judgment of supervisors to weigh the strengths and weaknesses of a bank's chosen approach, using these supervisory standards as a guide.

S. IRB institutions must have a fully specified process covering all aspects of quantification (reference data, estimation, mapping, and application). The quantification process, including the role and scope of expert judgment, must be fully documented and updated periodically.

A fully specified quantification process must describe how all four stages (data, estimation, mapping, and application) are implemented for each parameter. Documentation promotes consistency and allows third parties to review and replicate the entire process. Examples of third parties that might use the documentation include rating-system reviewers, auditors, and bank supervisors. Periodic updates to the process must be conducted to ensure that new data, analytical techniques, and evolving industry practice are incorporated into the quantification process.

S. Parameter estimates and related documentation must be updated regularly.

The parameter estimates must be updated at least annually, and the process for doing so must be documented in bank policy. The update should also evaluate the judgmental adjustments embedded in the estimates; new data or techniques may suggest a need to modify those adjustments. Particular attention should be given to new business lines or portfolios in which the mix of obligors is believed to have changed substantially. A material merger, acquisition, divestiture, or exit clearly raises questions about the continued applicability of the process and should trigger an intensive review and updating.

The updating process is particularly relevant for the reference data stage because new data become available all the time. New data must be incorporated, into the PD, LGD, and EAD estimates, using a well-defined process.

S. A bank must subject all aspects of the quantification process, including design and implementation, to an appropriate degree of independent review and validation.

An independent review is an assessment conducted by persons not accountable for the work being reviewed. The reviewers may be either internal or external parties. The review serves as a check that the quantification process is sound and works as intended; it should be broad-based, and must include all of the elements of the quantification process that lead to the ultimate estimates of PD, LGD, and EAD. The review must cover the full scope of validation: evaluation of the integrity of data inputs, analysis of the internal logic and consistency of the process, comparison with relevant benchmarks, and appropriate back-testing based on actual outcomes.

S. Judgmental adjustments may be an appropriate part of the quantification process, but must not be biased toward lower estimates of risk.

Judgment will inevitably play a role in the quantification process and may materially affect the estimates. Judgmental adjustments to estimates are often necessary because of some limitations on available reference data or because of inherent differences between the reference data and the bank's portfolio data. The bank must ensure that adjustments are not biased toward optimistically low parameter estimates for PD, LGD, and EAD. Individual assumptions are less important than broad patterns; consistent signs of judgmental decisions that lower parameter estimates materially may be evidence of bias.

The reasoning and empirical support for any adjustments, as well as the mechanics of the calculation, must be documented. The bank should conduct sensitivity analysis to demonstrate that the adjustment procedure is not biased toward reducing capital requirements. The analysis must consider the impact of any judgmental adjustments on estimates and risk weights, and must be fully documented.

S. Parameter estimates must incorporate a degree of conservatism that is appropriate for the overall robustness of the quantification process.

In estimating values of PD, LGD, and EAD should be as precise and accurate as possible. However, estimates of PD, LGD and EAD are statistics, and thus inherently subject to uncertainty and potential error. It is often possible to be reasonably confident that a risk component or other parameter lies within a particular range, but greater precision is difficult to achieve. Aspects of the ratings quantification process that are apt to introduce uncertainty and potential error include the following:

The estimation of coefficients of particular variables in a regression-based statistical default or severity model.

- The calculation of average default or loss rates for particular categories of credits in external default databases.
- The mapping between portfolio obligors or facilities and reference data when the set of common characteristics does not align exactly.

A general principle of the IRB approach is that a bank must adjust estimates conservatively in the presence of uncertainty or potential error. In many cases this corresponds to assigning a final parameter estimate that increases required capital relative to the best estimate produced through sound-practice estimation techniques. The extent of this conservative adjustment should be related to factors such as the relevance of the reference data, the quality of the mapping, the precision of the statistical estimates, and the amount of judgment used throughout the process. Margins of conservatism need not be added at each step; indeed, that could produce an excessively conservative result. The overall margin of conservatism should adequately account for all uncertainties and weaknesses; this is the general interpretation of requirements to incorporate appropriate degrees of conservatism. Improvements in the quantification process (use of better data, estimation techniques, and so on) may reduce the appropriate degree of conservatism over time.

Estimates of PD, LGD, EAD, or other parameters or coefficients should be presented with an accompanying sense of the statistical precision of the estimates; this facilitates an assessment of the appropriate degree of conservatism.

B. Probability of Default (PD)

Data

To estimate PD accurately, a bank must have a comprehensive reference data set with observations that are comparable to the bank's current portfolio of obligors. Clearly, the data set used for estimation should be similar to the portfolio to which such estimates will be applied. The same comparability standard applies to both internal and external data sets.

To ensure ongoing applicability of the reference data, a bank must assess the characteristics of its current obligors relative to the characteristics of obligors in the reference data. Such variables might include qualitative and quantitative obligor information, internal and external rating, rating dates, and line of business or geography. To this end, a bank must maintain documentation that fully describes all explanatory variables in the data set, including any changes to those variables over time. A well-defined and documented process must be in place to ensure that the reference data are updated as frequently as is practical, as fresh data become available or portfolio changes make necessary.

S. The sample for the reference data must be at least five years, and must include periods of economic stress during which default rates were relatively high.

To foster more robust estimation, banks should use longer time series when more than five years of data are available. However, the benefits of using a longer time series (longer than five years) may have to be weighed against a possible loss of data comparability. The older the reference data, the less similar they are likely to be to the bank's current portfolio; striking the correct balance is a matter of judgment. Reference obligors must not differ from the current portfolio obligors systematically in ways that seem likely to be related to obligor default risk. Otherwise, the derived PD estimates may not be applicable to the current portfolio.

Note that this principle does not simply restate the requirement for five years of data: periods of stress during which default rates are relatively high must be included in the data sample. Exclusion of such periods biases PD estimates downward and unjustifiably lowers regulatory capital requirements.

Example. A bank's reference data set covers the years 1987 through 2001. Each year includes identical data elements, and each year is similarly populated. For its grade PD estimates, the bank relies upon data from a sub-sample covering 1992 through 2001. The bank provides no justification for dropping the years from 1987 through 1991. The bank contends that it is not necessary to include those data, as the reference sample they use for estimation satisfies the five-year requirement. This practice is not consistent with the standard because the bank has not supported its decision to ignore available data. The fact that the excluded years include a recession would raise particular concerns.

S. The definition of default within the reference data must be reasonably consistent with the IRB definition of default.

Regardless of the source of the reference data, a bank must apply the same default definition throughout the quantification processes. This fosters consistent estimation across parameters and reduces the potential for undesired bias. In addition, consistent application of the same definition across banks will permit true horizontal analysis by supervisors and engaged market participants.

This standard applies to both internal and external reference data. For internal data, a bank's default definition is expected to be consistent with the IRB definition going forward. Banks will be expected to make appropriate adjustments to their data systems such that all defaults as defined for IRB are captured by the time a bank fully implements its IRB system. For any historical or external data that do not fully comply with the IRB definition of default, a bank must make conservative adjustments to reflect such discrepancies. Larger discrepancies require larger adjustments for conservatism.

Example. To identify defaults in its historical data, a bank applies a consistent definition of ''placed on nonaccrual.'' This definition is used in the bank's quantification exercises to estimate PD, LGD, and EAD. The bank recognizes that use of the nonaccrual definition fails to capture certain defaults as identified in the IRB rules. Specifically, the bank indicates that the following kinds of defaulted facilities would not have been placed on nonaccrual: (1) Credit obligations that were sold at a material credit-related economic loss, and (2) distressed restructurings. To be consistent with the standard, the bank must make a well-supported adjustment to its grade PD estimates to reflect the difference in the default definitions.

Estimation

Estimation of PD is the process by which characteristics of the reference data are related to default frequencies.[4] The relevant characteristics that help to determine the likelihood of default are referred to as ''drivers of default''. Drivers might include variables such as financial ratios, management expertise, industry, and geography.

S. Estimates of default rates must be empirically based and must represent a long-run average.

Estimates must capture average default experience over a reasonable mix of high-default and low-default years of the economic cycle. The average is labeled ''long-run'' because a long observation period would span both peaks and valleys of the economic cycle. The emphasis should not be on time-span; the long-run average concept captures the breadth, not the length, of experience.

If the reference data are characterized by internal or external rating grades, one estimation approach is to calculate the mean of one-year realized default rates for each grade, giving equal weight to each year's realized default rate. PD estimates generally should be calculated in this manner.

Another approach is to pool obligors in a given grade over a number of years and then calculate the mean default rate. In this case, each year's default rate is weighted by the number of obligors. This approach may underestimate default rates. For example, if lending declines in recessions so that obligors are fewer in those years than in others, weighting by number of obligors would dilute the effect of the recession year on the overall mean. The obligor-weighted calculation, or another approach, will be allowed only if the bank can demonstrate that this approach provides a better estimate of the long-run average PD. At a minimum, this would involve comparing the results of both methods.

Statistical default prediction models may also play a role in PD estimation. For example, the characteristics of the reference data might include financial ratios or a distance-to-default measure, as defined by a specific implementation of a Merton-style structural model.

For a model-based approach to meet the requirement that ultimate grade PD estimates be long-run averages, the reference data used in the default model must meet the long-run requirement. For example, a model can be used to relate financial ratios to likelihood of default based on the outcome for the firms—default or non-default. Such a model must be calibrated to capture the default experience over a reasonable mix of good and bad years of the economic cycle. The same requirement would hold for a structural model; distance to default must be calibrated to default frequency using long-run experience. This applies to both internal and vendor models, and a bank must verify that this requirement is met.

Example 1. A bank uses external data from a rating agency to estimate PD. The PD estimate for each agency grade is calculated as the mean of yearly realized default rates over a time period (1980 through 2001) that includes several recessions and high-default years. The bank provides support that this time period adequately represents long-run experience. This illustrates an estimation method that is consistent with the standard.

Example 2a. Like the institution in example 1, a bank maps internal ratings to agency grades. The estimates for the agency grades are set indirectly, using the default probabilities from a default prediction model. The bank does so because although it links internal and agency grades, the bank views the default model's results as more predictive than the historical agency default experience. For each agency grade, the bank calculates a PD estimate as the mean of the model-based default probabilities for the agency-rated obligors. In order to meet the long-run requirement, the bank calculates the estimates over the seven years from 1995 through 2001. The bank demonstrates that this time period includes a reasonable mix of high-default and low-default experience. This estimation method is consistent with the standard.

Example 2b. In a variant of example 2a, a bank uses the mean default frequency per agency rating grade for a single year, such as 2001. Empirical evidence shows that the mean default frequency for agency grades varies substantially from year to year. A single year thus does not reflect the full range of experience, because a long-run average should be relatively stable year to year. Such instability makes this estimation method unacceptable.

Example 2c. Another bank calculates the agency grade PD estimates as the median default probability of companies in that grade. The bank does so without demonstrating that the median is a better statistical estimator than the mean. This estimation method is not consistent with the standard. A median gives less weight to obligors with high estimated default probabilities than a simple mean does. The difference between mean and median can be material because distributions of credits within grades often are substantially skewed toward higher default probabilities: the riskier obligors within a grade tend to have individual default probabilities that are substantially worse than the median, while the least risky have default probabilities only somewhat better than the median.

S. Judgmental adjustments may play an appropriate role in PD estimation, but must not be biased toward lower estimates.

The following examples illustrate how supervisors will evaluate adjustments:

Example 1. A bank uses the last five years of internal default history to estimate grade PDs. However, they recognize that the internal experience does not include any high-default years. In order to remedy this and still take advantage of its experience, the bank uses external agency data to adjust the estimates upward. Using the agency data, the bank calculates the ratio between the long-run average and the mean default rate per grade over the last five years. The bank assumes that the relationship observed in the agency data applies to its portfolio, and adjusts the estimates for the internal data accordingly. This practice is consistent with the standard.

Example 2. A bank uses internal default experience to estimate grade PDs. However, the bank has historically failed to recognize defaults when the loss on the default obligation was avoided by seizing collateral. The bank makes no adjustment for such missing defaults. The realized default rate using the more inclusive definition would be higher than that observed by the bank (and loss severity rates would be correspondingly lower). This practice would not be consistent with the standard, unless the bank demonstrates that the necessary adjustment is immaterial.

Mapping

Mapping is the process of establishing a correspondence between the bank's current obligors and the reference obligor data used in the default model. Hence, mapping involves identifying how default-related characteristics of the current portfolio correspond to the characteristics of reference obligors. Such characteristics might include financial and nonfinancial variables, and assigned ratings or grades.

Mapping can be thought of as taking each obligor in the bank's portfolio and characterizing it as if it were part of the reference data. There are two broad approaches to the mapping process:

Obligor mapping: Each portfolio obligor is mapped to the reference data based on its individual characteristics. For example, if a bank applies a default model, a default probability will be generated for each obligor. That individual default probability is then used to assign each obligor to a particular internal grade, based on the bank's established criteria. To obtain a final estimate of the grade PD in the subsequent application stage, the bank averages the default probabilities of individual obligors within each grade.

Grade mapping: Characteristics of the obligors within an internal grade are

[4] The New Basel Capital Accord produced by the Basel Committee on Banking Supervision discusses three techniques for PD estimation. IRB banks are not constrained to select from among these three techniques; they have broad flexibility to implement appropriate approaches to quantification. The three Basel techniques are best regarded not as a complete taxonomy of the possible approaches to PD estimation, but rather as illustrations of a few of the many possible approaches.

averaged or otherwise summarized to construct a ''typical'' or representative obligor for each grade. Then, the bank maps that representative obligor to the reference data. For example, if the bank uses a default model, the default probability associated with that typical obligor will serve as the grade PD in the application stage. Alternatively, the bank may map the typical obligor to a particular external rating grade based on quantitative and qualitative characteristics, and assign the long-run default rate for that rating to the internal grade in the application stage.

Either grade mapping or obligor mapping can be part of the quantification process; either method can produce a single PD estimate for each grade in the application stage. However, in the absence of other compelling considerations, banks should use obligor mapping for two reasons:

- First, default probabilities are nonlinear under many estimation approaches. As a result, the default probability of the typical obligor—the result of a grade mapping approach—is often lower than the mean of the individual obligor default probabilities from the obligor mapping approach. For example, consider a bank that maps to the S&P scale and uses historical S&P bond default rates. For ease of illustration, suppose that one internal grade contains only three obligors that individually map to BB, BB−, and B+. The historical default rates for these three grades are 1.07, 1.76, and 3.24 percent, respectively (based on 1981–2001 data). Using obligor mapping, those rates would be assigned directly to the three obligors, yielding a mean PD of 2.02 percent for the grade. Using grade mapping, the grade PD would be only 1.76, because the grade's typical obligor is rated BB−.
- Second, a hypothetical obligor with a grade's average characteristics may not represent well the risks presented by the grade's typical obligor. For example, a bank might observe that obligors with high leverage and low earnings variability have about the same default risk as obligors with low leverage and high earnings variability. These two types of obligors might both end up in the same grade, for example, Grade 6. If so, the typical obligor in Grade 6 would have moderate leverage and moderate earnings variability—a combination that might fail to reflect any of the individual obligors in Grade 6, and that could easily result in a PD for the grade that is too low.

A bank electing to use grade mapping instead of obligor mapping should be especially careful in choosing a ''typical'' obligor for each grade. Doing so typically requires that the bank examine the actual distribution of obligors within each grade, as well as the characteristics of those obligors. Banks should be aware that different measures of central tendency (such as mean, median, or mode) will give different results, and that these different results may have a material effect on a grade's PD; they must be able to justify their choice of a measure. Banks must have a clear and consistent policy toward the calculation.

S. The mapping must be based on a robust comparison of available data elements that are common to the portfolio and the reference data.

Sound mapping practice uses all common elements that are available in the data as the basis for mapping. If a bank chooses to ignore certain common variables or to weight some variables more heavily than others, those choices must be supported. Mapping should also take into account differences in rating philosophy (for example, point-in-time or through-the-cycle) between any ratings embedded in the reference data set and the bank's own rating regime.

A mapping should be plausible, and should be consistent with the rating philosophy established by the bank as part of its obligor rating policy. For a bank that uses grade mapping, levels and ranges of key variables within each internal grade should be close to values of similar variables for corresponding obligors within the reference data.

The standard allows for use of a limited set of common variables that are predictive of default risk, in part to permit flexibility in early years when data may be far from ideal. Nevertheless, banks will eventually be expected to use variables that are widely recognized as the most reliable predictors of default risk in mapping exercises. In the meantime, banks relying on data elements that are weak predictors must compensate by making their estimates more conservative. For example, leverage and cash flow are widely recognized to be reliable predictors of corporate default risk. Borrower size is also predictive, but less so. A mapping based solely on size is by nature less reliable than one based on leverage, cash flow, and size.

Example 1. In estimating PD, a bank relies on observed default rates on bonds in various agency grades for PD quantification. To map its internal grades to the agency grades, the bank identifies variables that together explain much of the rating variation in the bond sample. The bank then conducts a statistical analysis of those same variables within its portfolio of obligors, using a multivariate distance calculation to assign each portfolio obligor to the external rating whose characteristics it matches most closely (for example, assigning obligors to ratings so that the sum of squared differences between the external grade averages and the obligor's characteristics is minimized). This practice is broadly consistent with the standard.

Example 2. A bank uses grade mapping to link portfolio obligors to the reference data set described by agency ratings. The bank looks at publicly rated portfolio obligors within an internal grade to determine the most common external rating, does the same for all grades, and creates a correspondence between internal and external ratings. The strength of the correspondence is a function of the number of externally rated obligors within each grade, the distribution of those external ratings within each grade and the similarity of externally rated obligors in the grade to those not externally rated. This practice is broadly consistent with this standard, but would require a comparison of rating philosophies and may require adjustments and the addition of margins of conservatism.

S. A mapping process must be established for each reference data set and for each estimation model.

Banks should never assume that a mapping is self-evident. Even a rating system that has been explicitly designed to replicate external agency ratings may or may not be effective in producing a replica; formal mapping is still necessary. Indeed, in such a system the kind of analysis involved in mapping may help identify inconsistencies in the rating process itself.

A mapping process is needed even where the reference obligors come from internal historical experience. Banks must not assume that internal data do not require mapping, because changes in bank strategy or external economic forces may alter the composition of internal grades or the nature of the obligors in those grades over time. Mappings must be reaffirmed regardless of whether rating criteria or other aspects of the ratings system have undergone explicit changes during the period covered by the reference data set.

Banks often use multiple reference data sets, and then combine the resulting estimates to get a grade PD. A bank that does that must conduct a rigorous mapping process for each data set.

Supervisors expect all meaningful characteristics of obligors to be factored directly into the rating process; this should include characteristics like the obligor's industry or physical location. But in some circumstances, certain effects related to industry, geography, or other factors are not reflected in rating assignments or default estimates. In such cases, it may be appropriate for banks to capture the impact of the omissions by using different mappings for different business lines or types of obligors. Supervisors expect this practice to be transitional; banks will eventually be required to incorporate the omitted effects into the rating system and the estimation process as they are uncovered and documented, rather than adjusting the mapping.

Example 1. The bank maps its internal grades carefully to one rating agency, and then assumes a correspondence to another agency's scale despite known differences in the rating methods of the two agencies. The bank then applies a mean of the grade default rates from these two public debt-rating agencies to its internal grades. This practice is not consistent with the standard, because the bank should map to each agency's scale separately.

Example 2. A bank uses internal historical data as its reference data. The bank computes a mean default rate for each grade as the grade PD for capital purposes, and asserts that mapping is unnecessary because ''its strong credit culture ensures that a 4 is always a 4.'' This practice is not consistent with the standard, because no mapping has been done; there is no assurance that a representative obligor in a grade today is comparable to an obligor in that same grade in the past.

S. The mapping must be updated and independently validated regularly.

The appropriate mapping between a bank's portfolio and the reference data may change over time. For example, relationships between internal grades and external agency grades may change during the economic cycle because of differences in rating philosophy. Similarly, distance-to-default measures for obligors in a given grade may not be constant over time. These likely changes make it imperative that the bank update all mappings regularly.

Sound validation practices may include tests for internal consistency such as ''reverse mapping.'' Using this technique, a bank evaluates obligors from the reference data set as if they were subject to the bank's rating system (that is, part of the bank's current portfolio). The bank's mapping is then applied to these reverse-mapped obligors to see whether the mapped characterization of the reference obligor is consistent with that of the initial evaluation.[5] Another valuable technique is to apply different mapping methods and compare the results. For example, mappings based on financial ratio comparisons can be rechecked using mappings based on available external ratings.

Example. A bank mapped its internal grades to the rating scale of one public debt-rating agency in 1992. Since then, the bank has completed a major acquisition of another large bank and significantly changed its business mix in other ways. The bank continues to use the same mapping, without reassessing its validity. This practice is not consistent with the standard.

Application

In the application stage, the bank applies the PD estimation method to the current portfolio of obligors using the mapping process. It obtains final PD estimates for each rating grade, which will be used to calculate minimum regulatory capital. To arrive at those estimates, a bank may adjust the raw results derived from the estimation stage. For example, it might aggregate individual obligor default probabilities to the rating grade level, or smooth results because a rating grade's PD estimate was higher than a lower quality grade. The bank must explain and support all adjustments when documenting its quantification process.

Example. A bank uses external data to estimate long-run average PDs for each grade. The resulting PD estimate for Grade 2 is slightly higher than the estimate for Grade 3, even though Grade 2 is supposedly of higher credit quality. The bank uses statistics to demonstrate that this anomaly occurred because defaults are rare in the highest quality rating grades. The bank judgmentally adjusts the PD estimates for grades 2 and 3 to preserve the expected relationship between obligor grade and PD, but requires that total risk-weighted assets across both grades using the adjusted PD estimates be no less than total risk-weighted assets based on the unadjusted estimates, using a typical distribution of obligors across the two grades. Such an adjustment during the application stage is consistent with this guidance.

S. IRB institutions that aggregate the default probabilities of individual portfolio obligors when calculating PD estimates for internal grades must have a clear policy governing the aggregation process.

As noted above, mapping may be grade-based or obligor-based. Grade-based mappings naturally provide a single PD per grade, because the estimated default model is applied to the representative obligor for each grade. In contrast, obligor-based mappings must aggregate in some manner the individual PD estimates to the grade level. The expectation is that the grade PD estimate will be calculated as the mean. The bank will be allowed to calculate this estimate differently only if it can demonstrate that the alternative method provides a better estimate of the long-run average PD. To obtain this evidence, the bank must at least compare the results of both methods.

S. IRB institutions that combine estimates from multiple sets of reference data must have a clear policy governing the combination process, and must examine the sensitivity of the results to alternative combinations.

Because a bank should make use of as much information as possible when mapping, it will usually use multiple data sets. The manner in which the data or the estimates from those multiple data sets are combined is extremely important. A bank must document its justification for the particular combination methods selected. Those methods must be subject to appropriate approval and oversight.

The data may come from the same basic data source but from different time periods or from different data sources altogether. For example, banks often combine internal data with external data, use external data from different sample periods, or combine results from corporate-bond default databases with results from equity-based models of obligor default. Different combinations will produce different PD estimates. The bank should investigate alternative combinations and document the impact on the estimates. When ultimate results are highly sensitive to how estimates from different data sources are combined, the bank must choose among the alternatives conservatively.

C. Loss Given Default (LGD)

The LGD estimation process is similar to the PD estimation process. The bank identifies a reference data set of defaulted credits and relevant descriptive characteristics. Once the bank obtains these data sets (with the facility characteristics), it must select a technique to estimate the economic loss per dollar of exposure at default, for a defaulted exposure with a given array of characteristics. The bank's portfolio must then be mapped, so that the model can be applied to generate an estimate of LGD for each portfolio transaction or severity grade.

Data

Unlike reference data sets used for PD estimation, data sets for severity estimation contain only exposures to defaulting obligors. At least two broad categories of data are necessary to produce LGD estimates.

First, data must be available to calculate the actual economic loss experienced for each defaulted facility. Such data may include the market value of the facility at default, which can be

[5] For example, suppose a bank asserts that its Grade 3 corresponds to an S&P rating of A. Applying reverse mapping, the bank would take a sample of A-rated obligors from the reference data, run them through the bank's rating process (perhaps a simplified version), and check to see that those obligors usually receive a grade of 3 on the bank's internal scale.

used to proxy a recovery rate. Alternatively, economic loss may be calculated using the exposure at the time of default, loss of principal, interest, and fees, the present value of subsequent recoveries and related expenses (or the costs as calculated using an approved allocation method), and the appropriate discount rate.

Second, factors must be available to group the defaulted facilities in meaningful ways. Characteristics that are likely to be important in predicting loss rates include whether or not the facility is secured and the type and coverage of collateral if the facility is secured, seniority of the claim, general economic conditions, and obligor's industry. Although these factors have been found to be significant in existing academic and industry studies, a bank's quantification of LGD certainly need not be limited to these variables. For example, a bank might expand its loss severity research by examining many other potential drivers of severity (characteristics of an obligor that might help the bank predict the severity of a loss), including obligor size, line of business, geographic location, facility type, obligor ratings (internal or external), historical internal severity grade, or tenor of the relationship.

A bank must ensure that the reference data remains applicable to its current portfolio of facilities. It must implement established processes to ensure that reference data sets are updated when new data become available. All data sources, variables, and the overall processes concerning data collection and maintenance must be fully documented, and that documentation should be readily available for review.

S. The sample period for the reference data must be at least seven years, and must include periods of economic stress during which defaults were relatively high.

Seven years is the minimum sample period for the LGD reference data. A longer sample period is desirable, because more default observations will be available for analysis and may serve to refine severity estimates. In any case, a bank must select a sample period that includes episodes of economic stress, which are defined as periods with a relatively high number of defaults. Inclusion of stress periods increases the size and potentially the breadth of the reference data set. According to some empirical studies, the average loss rate is higher during periods of stress.

Example. A bank intends to rely primarily on internal data when quantifying all parameter estimates, including LGD. Its internal data cover the period 1994 through 2000. The bank will continue to extend its data set as time progresses. Its current policy mandates that credits be resolved within two years of default, and the data set contains the most recent data available. Although the current data set satisfies the seven-year requirement, the bank is aware that it does not include stress periods. In comparing its loss estimates with rates published in external studies for similarly stratified data, the bank observes that its estimates are systematically lower. To be consistent with the standard, the bank must take steps to include stress periods in its estimates.

S. The definition of default within the reference data must be reasonably consistent with the IRB definition of default.

This standard parallels a similar standard in the section on PD. The following examples illustrate how it applies in the case of LGD.

Example 1. For LGD estimation, a bank includes in its default data base only defaulted facilities that actually experience a loss, and excludes credits for which no loss was recorded because liquidated collateral covered the loss (effectively applying a ''loss given loss'' concept). This practice is not consistent with the standard because the bank's default definition for LGD is narrower than the IRB definition.

Example 2. A bank relies on external data sources to estimate LGD because it lacks sufficient internal data. One source uses ''bankruptcy filing'' to indicate default while another uses ''missed principal or interest payment,'' and the two sources result in significantly different loss estimates for the severity grades defined by the bank. The bank's practice is not consistent with the standard, and the bank should determine whether the definitions used in the reference data sets differ substantially from the IRB definition. If so, and the differences are difficult to quantify, the bank should seek other sources of reference data. For more minor differences, the bank may be able to make appropriate adjustments during the estimation stage.

Estimation

Estimation of LGD is the process by which characteristics of the reference data are related to loss severity. The relevant characteristics that help explain how severe losses tend to be upon default might include variables such as seniority, collateral, facility type, or business line.

S. The estimates of loss severity must be empirically based and must reflect the concept of ''economic loss.''

Loss severity is defined as economic loss, which is different from accounting measures of loss. Economic loss captures the value of recoveries and direct and indirect costs discounted to the time of default, and it should be measured for each defaulted facility. The scope of the cash flows included in recoveries and costs is meant to be broad. Workout costs that can be clearly attributed to certain facilities or types of facilities must be reflected in the bank's LGD assignments for those exposures. When such allocation is not practical, the bank may assign those costs using factors based on broad averages.

A bank must establish a discount rate that reflects the time value of money and the opportunity cost of funds to apply to recoveries and costs. The discount rate must be no less than the contract interest rate on new originations of a type similar to the transaction in question, for the lowest-quality grade in which a bank originates such transactions.[6] Where possible, the rate should reflect the fixed rate on newly originated exposures with term corresponding to the average resolution period of defaulting assets.

Ideally, severity should be measured once all recoveries and costs have been realized. However, a bank may not resolve a defaulted obligation for many years following default. For practical purposes, banks may choose to close the period of observation before this final resolution occurs—that is, at a point in time when most costs have been incurred and when recoveries are substantially complete. Banks that do so should estimate the additional costs and recoveries that would likely occur beyond this period and include them in the LGD estimates. A bank must document its choice of the period of observation, and how it estimated additional costs and recoveries beyond this period.

LGD for each type of exposure must be the loss per default (expressed as a percentage of exposure at default) expected during periods when default rates are relatively high. This expected loss rate is referred to as ''stress-condition LGD.'' For cases in which loss severities do not have a material degree of cyclical variability, use of the long-run default-weighted average is appropriate, although stress-condition LGD generally exceeds this average.

The drivers of severity can be linked to loss estimates in a number of ways. One approach is to segment the reference defaults into groups that do not overlap. For example, defaults could be grouped by business line, predominant collateral type, and loan-to-value coverage. The LGD estimate for each category is the mean loss calculated over the category's defaulted facilities. Loss must be calculated as the default-weighted average (where individual defaults receive equal weight) rather than the average of

[6] The appropriate discount rate for IRB purposes may differ from the contract rate required under FAS 114 for accounting purposes.

annual loss rates, and must be based on results from periods during which default rates were relatively numerous if loss rates are materially cyclical.

Banks can also draw estimates of LGD from a statistical model. For example, they can build a regression model of severity using data on loss severity and some quantitative measures of the loss drivers. Any model must meet the requirements for model validation discussed in Chapter 1. Other methods for computing LGD could also be appropriate.

Example 1. A bank has internal data on defaulted facilities, including information on business line, facility type, seniority, and predominant collateral type (if the facility is secured). The data allow for a reasonable calculation of economic loss. The data span eight years and include three years that can be termed high-default years. After analyzing the economic cycle using internal and external data, the bank concludes that the data show no evidence of material cyclical variability in loss severities, and that the default data span enough experience to allow estimation of a long-run average. On the basis of preliminary analysis, the bank determines that the drivers of loss severity for large corporate facilities are similar to those for middle-market loans, and that the two groups can be estimated as a pool. Again on the basis of preliminary analysis, the bank segments this pool by seniority and by six collateral groupings, including unsecured. These groupings contain enough defaults to allow reasonably precise estimates. The loss severity estimates are then calculated by averaging loss rates within each segment. This practice is consistent with the standard.

Example 2. A bank uses internal data in which information on security and seniority is lacking. The bank groups corporate and middle-market defaulted facilities into a single pool and calculates the LGD estimate as the mean loss rate. No adjustments for the lack of data are made in the estimation or application steps. This practice is unacceptable because there is ample external evidence that security and seniority matter in these segments. A bank with such limited internal default data must incorporate external or pooled data into the estimation.

Example 3. A bank determines that a business unit—for example, a unit dedicated to a particular type of asset-based lending—forms a homogeneous pool for the purposes of estimating loss severity. That is, although the facilities in this pool may differ in some respects, the bank determines that they share a similar loss experience in default. The bank must provide reasonable support for this pooling through analysis of lending practices and available internal and external data. In this example, the mean of a single segment is consistent with the standard.

S. Judgmental adjustments may play an appropriate role in LGD estimation, but must not be biased toward lower estimates.

It is difficult to make general statements about good and bad practices in this area, because adjustments can take many different forms. The following examples illustrate how supervisors would be likely to evaluate particular adjustments observed in practice.

Example 1. A bank divides observed defaults into segments according to collateral type. One of the segments has too few observations to produce a reliable estimate. Relying on external data and judgment, the bank determines that the segment's estimated severity of loss falls somewhere between the estimates for two other categories. This segment's severity is set judgmentally to be the mean of the estimates for the other segments. This practice is consistent with the standard.

Example 2. A bank does not know when recoveries (and related costs) occurred in a portfolio segment; therefore, it cannot properly discount the segment's cash flows. However, the bank has sufficient internal data to calculate economic loss for defaulted facilities in another portfolio segment. The bank can support the assumption that the timing of cash flows for the two segments is comparable. Using the available data and informed judgment, the bank estimates that the measured loss without discounting should be grossed up to account for the time value of money and the opportunity cost of funds. This practice is consistent with the standard.

Example 3. A bank segments internal defaults in a business unit by some factors, including collateral. Although the available internal and external evidence indicates a higher LGD, the bank judgmentally assigns a loss estimate of 2 percent for facilities secured by cash collateral. The basis for this adjustment is that the lower estimate is justified by the expectation that the bank would do a better job of following policies for monitoring cash collateral in the future. Such an adjustment is generally not appropriate because it is based on projections of future performance rather than realized experience. This practice is not consistent with the standard.

Mapping

LGD mapping follows the same general principles that PD mapping does. A mapping must be plausible and must be based on a comparison of severity-related data elements common to both the reference data and the current portfolio. The mapping approach is expected to be unbiased, such that the exercise of judgment does not consistently lower LGD estimates. The default definitions in the reference data and the current portfolio of obligors should be comparable. The mapping process must be updated regularly, well-documented, and independently reviewed.

S. A bank must conduct a robust comparison of available common elements in the reference data and the portfolio.

Mapping involves matching facility-specific data elements available in the current portfolio to the factors in the reference data set used to estimate expected loss severity rates. Examples of factors that influence loss rates include collateral type and coverage, seniority, industry, and location.

At least three kinds of mapping challenges may arise. First, even if similarly named variables are available in the reference data and portfolio data, they may not be directly comparable. For example, the definition of particular collateral types, or the meaning of "secured," may vary from one application to another. Hence, a bank must ensure that linked variables are truly similar. Although adjustments to enhance comparability can be appropriate, they must be rigorously developed and documented. Second, levels of aggregation may vary. For example, the reference data may only broadly identify collateral types, such as financial and nonfinancial. The bank's information systems for its portfolio might supply more detail, with a wide variety of collateral type identifiers. To apply the estimates derived from the reference data, the internal data must be regrouped to match the coarser level of aggregation in the reference data. Third, reference data often do not include workout costs and will often use different discounting. Judgmental adjustments for such problems must be well-documented and, as much as possible, empirically based.

S. A mapping process must be established for each reference data set and for each estimation model.

Mapping is never self-evident. Even when reference data are drawn from internal default experience, a bank must still link the characteristics of the reference data with those of the current portfolio.

Different data sets and different approaches to severity estimation may be entirely appropriate, especially for different business segments or product lines. Each mapping process must be specified and documented.

Application

At the application stage, banks apply the LGD estimation framework to their current portfolio of credit exposures. Doing so might require them to aggregate individual LGD estimates into broader averages (for example, into discrete severity grades) or to combine estimates in various ways.

The inherent variability of recovery, due in part to unanticipated circumstances, demonstrates that no facility type is wholly risk-free, regardless of structure, collateral type, or collateral coverage. The existence of recovery risk dictates that application of a zero percent LGD is not acceptable.

S. IRB institutions that aggregate LGD estimates for severity grades from individual exposures within those grades must have a clear policy governing the aggregation process.

Banks with discrete severity grades compute a single estimate of LGD for a representative exposure within each of those grades. If a bank with a discrete scale of severity grades maps those grades to the reference data using grade mapping, there will be a single estimate of LGD for each grade, and the bank does not need to aggregate further. However, if the bank maps at the individual transaction level, the bank may then choose to aggregate those individual LGD estimates to the grade level and use the grade LGD in capital calculations. Because different methods of aggregation are possible, a bank must have a clear policy regarding how aggregation should be accomplished; in general, simple averaging is preferred. (This standard is irrelevant for banks that choose to assign LGD estimates directly to individual exposures rather than grades, because aggregation is not required in that case.)

S. An IRB institution must have a policy describing how it combines multiple sets of reference data.

Multiple data sets may produce superior estimates of loss severity, if the results are appropriately combined. Combining such sets differently usually produces different estimates of LGD. As a matter of internal policy, a bank should investigate alternative combinations, and document the impact on the estimates. If the results are highly sensitive to the manner in which different data sources are combined, the bank must choose conservatively among the alternatives.

D. Exposure at Default (EAD)

Compared with PD and LGD quantification, EAD quantification is less advanced. As such, it is addressed in somewhat less detail in this guidance than are PD and LGD quantification. Banks should continue to innovate in the area EAD estimation, refining and improving practices in EAD measurement and prediction. Additional supervisory guidance will be provided as more data become available and estimation techniques evolve.

A bank must provide an estimate of expected EAD for each facility in its portfolio. EAD is defined as the bank's expected gross dollar exposure of the facility upon the obligor's default. For fixed exposures like term loans, EAD is equal to the current amount outstanding. For variable exposures such as loan commitments or lines of credit, exposure is equal to current outstandings plus an estimate of additional drawings up to the time of default. This additional drawdown, identified as loan equivalent exposure (LEQ) in many institutions, is typically expressed as a percentage of the current total committed but undrawn amount. EAD can thus be represented as:

EAD = current outstanding + LEQ × (total committed − current outstanding)

As it is the LEQ that must be estimated, LEQ is the focus of this guidance.

Even though EAD estimation is less sophisticated than PD and LGD estimation, a bank still develops EAD estimates by working through the four stages that produce the other types of quantification: The bank must use a reference data set; it must apply an estimation technique to produce an expected total dollar exposure at default for a facility with a given array of characteristics; it must map its current portfolio to the reference data; and, by applying the estimation model, it must generate an EAD estimate for each portfolio facility or facility-type, as the case may be.

Data

Like reference data sets used for LGD estimation, LEQ data sets contain only exposures to defaulting obligors. In many cases, the same reference data may be used for both LGD and LEQ. In addition to relevant descriptive characteristics (referred to as ''drivers'') that can be used in estimation, the reference data must include historical information on the exposure (both drawn and undrawn amounts) as of some date prior to default, as well as the drawn exposure at the date of default.

As discussed below under ''Estimation,'' LEQ estimates may be developed using either a cohort method or a fixed-horizon method. The bank's reference data set must be structured so that it is consistent with the estimation method the bank applies. Thus, the data must include information on the total commitment, the undrawn amount, and the exposure drivers for each defaulted facility, either at fixed calendar dates for the cohort method or at a fixed interval prior to the default date for the fixed-horizon method.

The reference data must contain variables that enable the bank to group the exposures to defaulted obligors in meaningful ways. Obligor and facility risk ratings are commonly believed to be significant characteristics for predicting additional drawdown. Since less empirical research has been done on EAD estimation, little is known about other potential drivers of EAD. Among the many possibilities, banks may consider time from origination, time to expiration or renewal, economic conditions, risk rating changes, or certain types of covenants. Some potential drivers may be linked to a bank's credit risk management skills, while others may be exogenous. Industry practice is likely to improve as banks extend their research to identify other meaningful drivers of EAD.

A bank must ensure continued applicability of the reference data to its current portfolio of facilities. The reference data must include the types of variable exposures found in a bank's current portfolio. The definitions of default and exposure in the reference data should be consistent with the IRB definition of default, and consistent with the definitions used for PD and LGD quantification. Established processes must be in place to ensure that reference data sets are updated when new data are available. All data sources, variables, and the overall processes governing data collection and maintenance must be fully documented, and that documentation should be readily available for review.

Seven years of data are required for EAD (or LEQ) estimation. The sample should include periods during which default rates were relatively high, and ideally cover a complete economic cycle.

Estimation

To derive LEQ estimates, characteristics of the reference data are related to additional drawings preceding a default event. The estimation process must be capable of producing a plausible estimate of LEQ to support the EAD calculation for each facility. Two broad types of estimation methods are used in practice, the cohort method and the fixed-horizon method.

Under the cohort method, a bank groups defaults into discrete calendar periods (such as a year or a quarter). The bank then estimates the relationship between the drivers as of the start of that calendar period, and EAD or LEQ for each exposure to a defaulter. For each exposure category (that is, for each combination of exposure drivers identified by the bank), the LEQ estimate is calculated as the mean additional drawing for facilities in that category. To combine results for multiple periods into a single long-run average, the period-by-period means should be weighted by the proportion of defaults occurring in each period.

Under the fixed-horizon method, for each exposure to a defaulted obligor the bank compares additional drawdowns to the total commitment but undrawn amount that existed at the start of a fixed interval prior to the date of the default (the horizon). For example, the bank might base its estimates on a reference data set that supplies the actual exposure at default along with the drawn and undrawn amounts (as well as relevant drivers) at a date a fixed number of months prior to the date of each default, regardless of the actual calendar date on which the default occurred. Estimates of LEQ are computed from the average drawdowns that occur over the fixed-horizon interval, for whatever combinations of the driving variables the bank has determined are relevant for explaining and predicting exposure at default.

Evidence may indicate that LEQ estimates are positively correlated with economic downturns; that is, it may be that LEQs increase during high-default periods. If so, the higher drawdowns that occur during high-default periods are denoted ''stress-condition LEQs,'' analogous to the ''stress-condition LGDs'' discussed earlier in this chapter. For any exposure type whose LEQ estimates exhibit material cyclicality, a bank must use the stress-condition LEQ for purposes of calculating EAD.

In general, all available data should be used; particular observations or time periods should not be excluded from the data sample. Any adjustments a bank makes to the estimation results should be justified and fully documented. The analysis should be refreshed periodically as new data become available, and a bank should have a process in place to ensure that advances in analytical techniques and industry practice are considered as they emerge and are incorporated as appropriate. LEQ estimates should be updated at least annually. Detailed documentation, ongoing validation, and adequate oversight are fundamental controls that support a sound estimation process.

Mapping

If the same variables that drive exposure in the reference data are also available for facilities in the portfolio, mapping may be relatively easy. However, the bank must still review the definitions to ensure that variables that seem to be the same actually are. If the relevant variables are not available in a bank's current portfolio information system, the bank will encounter the same mapping complexities that it does when mapping for PD and LGD in similar circumstances. A bank should have well-documented policies that govern the mapping. Any exceptions to mapping policy should be reviewed, justified and fully documented. Mapping may be done for each exposure or for broad categories of exposure; the latter would be analogous to the ''grade mapping'' discussed earlier in this chapter.

Application

In the application stage, the estimated relationship between drivers and LEQ is applied to the bank's actual portfolio. To ensure that estimated EAD is at least as large as the currently drawn amount for all exposures, LEQs must not be negative. Multiple reference data sets may be used for LEQ estimation and combined at the application stage; those combinations should be rigorously developed, approved, and documented. Any smoothing or use of expert judgment to adjust the results should be well-justified and clearly documented. This includes any adjustment for definitions of default that do not meet the supervisory standards. The less robust the process, the more conservative the result should be.

Some facility types may be treated as exceptions, and assigned an LEQ that does not vary with characteristics such as line of business or risk rating. Such exceptional treatment should be clearly justified, and the justification should be fully documented.

EAD may be particularly sensitive to changes in the way banks manage individual credits. For example, a change in policy regarding covenants may have a significant impact on LEQ. When such changes take place, the bank should consider them when making its estimates—and it should do so from a conservative point of view. Policy changes likely to significantly increase LEQ should prompt immediate increases in LEQ estimates. If a bank's policy changes seem likely to reduce LEQ, estimates should be reduced only after the bank accumulates a significant amount of actual experience under the new policy to support the reductions.

E. Maturity (M)

A bank must assign a value of effective remaining maturity (M) to each credit exposure in its portfolio. In general, M is the weighted-average number of years to receipt of the cash flows the bank expects under the contractual terms of the exposure, where the weights are equal to the fraction of the total undiscounted cash flow to be received at each date. Mathematically, M is given by:

$$M = \sum_t t \times w_t$$

where w_t is the fraction of the total cash flow received at time t, that is:

$$w_t = C_t / \sum_t C_t$$

C_t is the undiscounted cash flow received at time t, with t measured in years from the date of the calculation of M.

Effective maturity, sometimes referred to as ''average life,'' need not be a whole number, and often is not. For example, if 33 percent of the cash flow is expected at the end of one year (t=1) and the other 67 percent two years from today (t=2), then M is calculated as:

$M = (1\times0.33) + (2\times0.67) = 1.67$

for an effective maturity of 1.67 years. This value of M would be used in the IRB capital calculation.

The relevant cash flows are the future payments the bank expects to receive from the obligor, regardless of form; they may include payments of interest or fees, principal repayments, or other types of payments depending on the structure of the transaction. For exposures whose cash flow schedule is virtually predetermined unless the obligors defaults (fixed-rate loans, for example), the calculation of the weighted-average remaining maturity is straightforward, using the scheduled timing and amounts of the individual undiscounted cash flows. These cash flows should be the contractually expected payments; the bank should not take into account the possibility of delayed or reduced cash flows due to potential future default.

Cash flows associated with other types of credit exposures may be somewhat less certain. In such cases, the bank must establish a method of projecting expected cash flows. In general, the method used for any exposure should be the same as the one used by the bank for purposes of valuation or risk management. The method must be well-documented and subject to independent review and approval. A bank must demonstrate that the method used is standard industry practice, that it is widely used within the bank for purposes other than regulatory capital calculations, or both.

To be conservative, a bank may set M equal to the maximum number of years the obligor could take to fully discharge the contractual obligation (provided that the maximum is not longer than five years, as noted below). In many cases, this maximum will correspond to the stated or nominal maturity of the instrument. Banks must make this conservative choice (maximum nominal maturity) if the timing and amounts of the cash flows on the exposure cannot be projected with a reasonable degree of confidence.

Certain over-the-counter derivatives contracts and repurchase transactions may be subject to master netting agreements. In such cases, the bank may compute a single value of M for the transactions as a group by weighting each individual transaction's effective maturity by that transaction's share of the total notional value subject to the netting agreement, and summing the result across all of the transactions.

For IRB capital calculations, the value of M for any exposure is subject to certain upper and lower limits, regardless of the actual effective maturity of the exposure. In all cases, the value of M should be no greater than 5 years. If an exposure clearly has an effective maturity that exceeds this upper limit, the bank may simply use a value of M=5 rather than calculating the actual effective maturity.

For most exposures, the value of M must be no less than one year. For certain short-term exposures (repo-style transactions, money market transactions, trade finance-related transactions, and exposures arising from payment and settlement processes) that are not part of a bank's ongoing financing of a borrower and that have an original maturity of less than three months, M may be set as low as one day. For over-the-counter derivative and repurchase-style transactions subject to a master netting agreement, weighted average maturity must be set at no less than five days.

F. Validation

Values of PD, LGD, and EAD are estimates with implications for credit risk and the future performance of a bank's credit portfolio under IRB; in essence, they are forecasts. ''Validation'' of these estimates describes the full range of activities used to assess their quality as forecasts of default rates, loss severity rates, and exposures at default. Chapter 1 discusses validation of IRB systems in general; this section focuses specifically on ratings quantification, which includes the assignment of PD to obligor grades and the assignment of LGD, EAD, and M to exposures.

S. A validation process must cover all aspects of IRB quantification.

Banks must have a process for validating IRB quantification; their policies must state who is accountable for validation, and describe the actions that will proceed from the different possible results. Validation should focus on the three estimated IRB parameters (PD, LGD, and EAD). Although the established validation process should result in an overall assessment of IRB quantification for each parameter, it also must cover each of the four stages of the quantification process as described in preceding sections of this chapter (data, estimation, mapping, and application). The validation process must be fully documented, and must be approved by appropriate levels of the bank's senior management. The process must be updated periodically to incorporate new developments in validation practices and to ensure that validation methods remain appropriate; documentation must be updated whenever validation methods change.

Banks should use a variety of validation approaches or tools; no single validation tool can completely and conclusively assess IRB quantification. Three broad types of tools that are useful in this regard are evaluation of the conceptual soundness of the approach to quantification (evaluation of logic), comparison to other sources of data or estimates (benchmarking), and comparisons of actual outcomes to predictions (back-testing). Each of these types of tools has a role to play in validation, although the role varies across the four stages of quantification.

Evaluation of logic is essential in validating all stages of the quantification process. The quantification process requires banks to adopt methods, choose variables, and make adjustments; each of these actions requires an exercise of judgment. Validation should ensure that these judgments are plausible and informed.

A bank should also validate estimates by comparing them with relevant external sources, a process broadly described as benchmarking. ''External'' in this context refers to anything other than the specific reference data, estimation approach, or mapping under consideration. Reference data can be compared with other data sources; choices of variables can be compared with similar choices made by others; estimation results can be compared with the results of alternative estimation methods using the same reference data. Other data sources may show that default and severity rates across the economy or the banking system are high or low relative to other periods, or may reveal unusual effects in parts of the quality spectrum.

Effective validation must compare actual results with predictions. Such comparisons, often referred to as ''back-testing,'' are valuable comprehensive tests of the rating system and its quantification. However, they are only one element of the broader validation regime, and should not be a bank's only method of validation. Because they test the results of the rating system as a whole, they are unlikely to identify specific reasons for any divergence between expectations and realizations. Rather they will indicate only that further investigation is necessary.

By applying back-testing to the reference data set as it is updated with new data, a bank can improve the estimation process. To further improve the process, a bank must regularly compare realized default rates, loss severities, and exposure-at-default experience from its portfolio with the PD, LGD, and EAD estimates on which capital calculations are based. Realizations should be compared with expected ranges based on the estimates. These expected ranges should take into account the bank's rating philosophy (the relative weight given to current and stress conditions in assigning ratings). Depending on that philosophy, year-by-year realized default rates and loss severities may be expected to differ significantly from the long-run average. If a bank adjusts final estimates to be conservative, it should likely do its back-testing on the unadjusted estimates.

A bank's quantitative testing methods and other validation techniques should be robust to economic cycles. A sound validation process should take business cycles into account, and any adjustments for stages of the cycle should be clearly specified in advance and fully documented as part of the validation policy. The fact that a year has been ''unusual'' should not be taken as a reason to abandon the bank's standard validation practices.

S. A bank must comprehensively validate parameter estimates at least annually, must document the results, and must report these results to senior management.

A full and comprehensive annual validation is a minimum for effective risk management under IRB. More frequent validation may be appropriate for certain parts of the IRB system and in certain circumstances; for example, during high-default periods, banks should compute realized default and loss severity rates more frequently, perhaps quarterly. They must document the results of validation, and must report them to appropriate levels of senior risk management.

S. The validation policy must outline appropriate remedial responses to the results of parameter validation.

The goal of validation should be to continually improve the rating process and its quantification. To this end, the bank should establish thresholds or accuracy tolerances for validation results. Results that breach thresholds should bring an appropriate response; that response should depend on the results and should not necessarily be to adjust the parameter estimates. When realized default, severity, or exposures rates diverge from expected ranges, those divergences may point to issues in the estimation or mapping elements of quantification. They may also indicate potential problems in other parts of the ratings assignment process. The bank's validation policy must describe (at least in broad terms) the types of responses that should be considered when relevant action thresholds are crossed.

Appendix to Part III: Illustrations of the Quantification Process

This appendix provides examples to show how the logical framework described in this guidance, with its four stages (data, estimation, mapping, and application), applies when analyzing typical current bank practices. The framework is broadly applicable—for PD or LGD or EAD; using internal, external, or pooled reference data; for simple or complex estimation methods—although the issues and concerns that arise at each stage depend on a bank's approach. These examples are intended only to illustrate the logic of the four-stage IRB quantification framework, and should not be taken to endorse the particular techniques presented in the examples. In fact, certain aspects of the examples are not consistent with the standards outlined in this guidance.

Example 1: PD Estimation From Bond Data

- A bank establishes a correspondence between its internal grades and external rating agency grades; the bank has determined that its Grade 4 is equivalent to ¾ BB and ¼ B on the Standard and Poor's scale.
- The bank regularly obtains published estimates of mean default frequencies for publicly rated BB and B obligors in North America from 1970 through 2002.
- The BB and B historical default frequencies are weighted 75/25, and the result is a preliminary PD for the bank's internal Grade 4 credits.
- However, the bank then increases the PD by 10 percent to account for the fact that the S&P definition of default is more lenient than the IRB definition.
- The bank makes a further adjustment to ensure that the resulting grade PD is greater than the PD attributed to Grade 3 and less than the PD attributed to Grade 5.
- The result is the final PD estimate for Grade 4.

Process Analysis for Example 1

Data—The reference data set consists of issuers of publicly rated debt in North America over the period 1970 through 2002. The data description is very basic: each issuer in the reference data is described only by its rating (such as AAA, AA, A, BBB, and so on).

Estimation—The bank could have estimated default rates itself using a database purchased from Standard and Poor's, but since these estimates would just be the mean default rates per year for each grade, the bank could just as well (and in this example does) use the published historical default rates from S&P; in essence, the estimation step has been outsourced to S&P. The 10 percent adjustment of PD is part of the estimation process in this case because the adjustment was made prior to the application of the agency default rates to the internal portfolio data.

Mapping—The bank's mapping is an example of a grade mapping; internal Grade 4 is linked to the 75/25 mix of BB and B. Based on the limited information presented in the example, this step should be explored further. Specifically, how did the bank determine the 75/25 mix?

Application—Although the application step is relatively straightforward in this case, the bank does make the adjustment of the Grade 4 PD estimate to give it the desired relationship to the adjacent grades. This adjustment is part of the application stage because it is made after the adjusted agency default rates are applied to the internal grades.

Example 2: PD Estimation Using a Merton-Type Equity-Based Model

- A bank obtains a 20-year database of North American firms with publicly traded equity, some of which defaulted during the 20-year period.
- The bank uses the Merton approach to modeling equity in these firms as a contingent claim, constructing an estimate of each firm's distance-to-default at the start of each year in the database. The bank then ranks the firm-years within the database by distance-to-default, divides the ordered observations into 20 equal groups or buckets, and computes a mean historical one-year default frequency for each bucket. That default frequency is taken as an estimate of the applicable PD for any obligor within the range of distance-to-default values represented by each of the 20 buckets.
- The bank next looks at all obligors with publicly traded shares within each of its internal grades, applies the same Merton-type model to compute distance-to-default at quarter-end, sorts these observations into the 20 buckets from the previous step, and assigns the corresponding PD estimate.
- For each internal grade, the bank computes the mean of the individual obligor default probabilities and uses that average as the grade PD.

Process Analysis for Example 2

Data—The reference data set consists of the North American firms with publicly traded equity in the acquired database. The reference data are described in this case by a single variable, specifically an identifier of the specific distance-to-default range from the Merton model (one of the 20 possible in this case) into which a firm falls in any year.

Estimation—The estimation step is simple: the average default rate is calculated for each distance-to-default bucket. Since the data cover 20 years and a wide range of economic conditions, the resulting estimates satisfy the long-run average requirement.

Mapping—The bank maps selected portfolio obligors to the reference data set using the distance-to-default generated by the Merton model. However, not all obligors can be mapped, since not all have traded equity. This introduces an element of uncertainty into the mapping that requires additional analysis by the bank: were the mapped obligors representative of other obligors in the same grade? The bank would need to demonstrate comparability between the publicly traded portfolio obligors and those not publicly traded. It may be appropriate for the bank to make conservative adjustments to its ultimate PD estimates to compensate for the uncertainty in the mapping. The bank also would need further analysis to demonstrate that the implied distance-to-default for each internal grade represented long-run expectations for obligors assigned to that grade; this could involve computing the Merton model for portfolio obligors over several years of relevant history that span a wide range of credit conditions.

Application—The final step is aggregation of individual obligors to the grade level through calculation of the mean for each grade, and application of this grade PD to all obligors in the grade. The bank might also choose to modify PD assignments further at this stage, combining PD estimates derived from other sources, applying adjustments for cyclicality, introducing an appropriate degree of conservatism, or making other adjustments.

Example 3: LGD Estimation From Internal Default Data

- For each loan in its portfolio, a bank records collateral coverage as a percentage, as well as which of four types of collateral applies.
- A bank has retained data on all defaulted loans since 1995. For each defaulted loan in the database, the bank has a record of the collateral type within the same four broad categories. However, collateral coverage is only recorded at three levels (low, moderate, or high, depending on the ratio of collateral to exposure at default).
- The bank also records the timing and discounted value of recoveries net of workout costs for each defaulted loan in the database. Cash flows are tracked from the date of default to a ''resolution date,'' defined as the point at which the remaining balance is less than 5 percent of the exposure at the time of default. A recovery percentage is computed, equal to the value of recoveries discounted to the date of default, divided by the exposure at default.
- For each cell (each of the 12 combinations of collateral type and coverage), the bank computes a simple mean LGD percentage as the mean of one minus the recovery percentage. One of the categories has a mean LGD of less than zero (recoveries have exceeded exposure on average), so the bank sets the LGD at zero to be conservative.
- The bank assigns an estimate of expected LGD to each loan in the current portfolio by using collateral information to slot it into one of the 12 cells. The bank then applies the mean historical LGD for that cell and adjusts the result upward by 10 percent to compensate for the fact that the loss data come from a period believed to be unusually good economic performance.

Process Analysis for Example 3

Data—The reference data is the collection of historical defaults with the loss amounts from the bank's historical portfolio. The reference data are described by the two categorical variables (levels of collateral coverage and types of collateral). It would be important to determine whether the defaults over the past few years are comparable to defaults from the current portfolio. One would also want to ask why the bank ignores potentially valuable information by converting the continuous data on collateral coverage into a trimodal categorical variable.

Estimation—Conceptually, the bank is using a "loss severity model" in which 12 binary variables, one for each loan coverage/type combination, explain the percentage loss. The coefficients on the variables are just the mean loss figures from the reference data.

Mapping—Mapping in this case is fairly straightforward, since all of the relevant characteristics of the reference data are also in the loan system for the current portfolio. However, the bank should determine whether the variables are being recorded in the same way (for example, the same definitions of collateral types), otherwise some adjustment might be needed.

Application—The bank is able to apply the loss model by simply plugging in the relevant values for the current portfolio (or what amounts to the same thing, looking up the cell mean). The bank's assignment of zero LGD for one of the cells merits special attention; while the bank represented this assignment as conservative, the adjustment does not satisfy the supervisory requirement that LGD must exceed zero. A larger upward adjustment is necessary. Finally, the upward adjustment of the LGD numbers to account for the benign environment in which the reference data were generated presents one additional wrinkle. The bank must provide a well-documented, empirically based analysis of why a 10 percent upward adjustment is sufficient.

IV. Data Maintenance

A. Overview

Institutions using the IRB approach for regulatory capital purposes will need advanced data management practices to produce credible and reliable risk estimates. The guiding principle governing an IRB data maintenance system is that it must support the requirements for the quantification, validation, control and oversight mechanisms described in this guidance, as well as the institution's broader risk management and reporting needs. The precise data elements to be collected will be dictated by the features and methodology of the IRB system employed by the institution. The necessary data elements will therefore vary by institution and even among business lines within an institution.

Institutions will have latitude in managing their data, subject to the following key data maintenance standards:

Life Cycle Tracking—institutions must collect, maintain, and analyze essential data for obligors and facilities throughout the life and disposition of the credit exposure.

Rating Assignment Data—institutions must capture all significant quantitative and qualitative factors used to assign the obligor and loss severity ratings.

Support of IRB System—data collected by institutions must be of sufficient depth, scope, and reliability to:

- Validate IRB system processes,
- Validate parameters,
- Refine the IRB system,
- Develop internal parameter estimates,
- Apply improvements historically,
- Calculate capital ratios,
- Produce internal and public reports, and
- Support risk management.

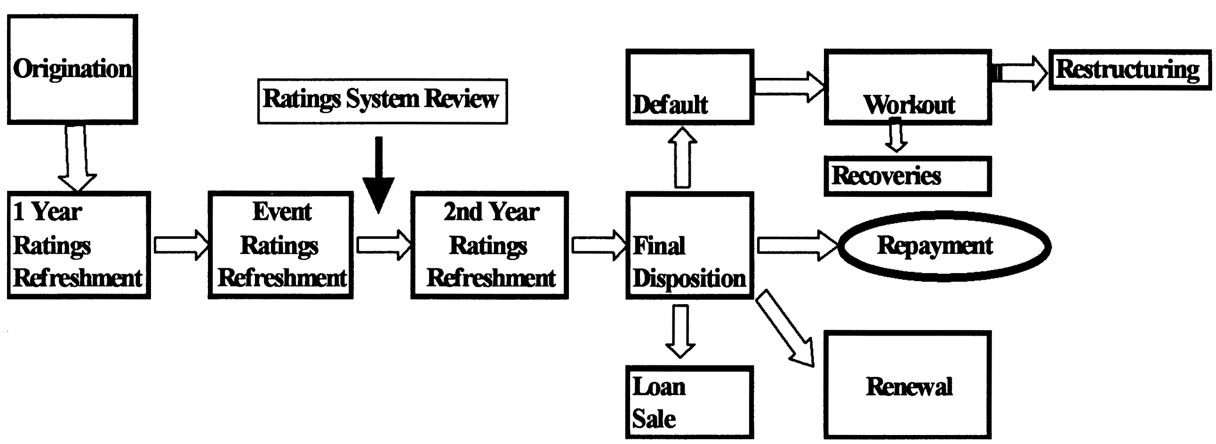
This chapter covers the requirements for maintaining internal data. Reference data sets used for estimating IRB parameters are discussed in Chapter 2.

B. Data Maintenance Framework

Life Cycle Tracking

S. Institutions must collect, maintain, and analyze essential data for obligors and facilities throughout the life and disposition of the credit exposure.

Using a life cycle or "cradle to grave" concept for each obligor and facility supports front-end validation, back-testing, system refinements and risk parameter estimates. A depiction of life-cycle tracking follows:



Data elements must be recorded at origination and whenever the rating is reviewed, regardless of whether the rating is actually changed. Data elements associated with current and past ratings must be retained and include the following:

- Key borrower and facility characteristics,
- Ratings for obligor and loss severity grades,
- Key factors used to assign the ratings,
- Person or model responsible for assigning the rating,
- Date rating assigned, and
- Overrides to the rating and authorizing individual.

At disposition, data elements must include:

- Nature of disposition: renewal, repayment, loan sale, default, restructuring,
- For defaults: exposure, actual recoveries, source of recoveries, costs of workouts and timing,
- Guarantor support,
- Sale price for loans sold, and
- Other key elements that the bank deems necessary.

Rating Assignment Data

S. Institutions must capture all significant quantitative and qualitative factors used to assign the obligor and loss severity rating.

Assigning a rating to an obligor requires the systematic collection of various borrower characteristics as these factors are critical to validating the rating system. Obligors are rated using various methods, as discussed in Chapter 1. Each of these methods presents different challenges for input collection. For example, in judgmental rating systems, the factors used in the ratings decision have not traditionally been explicitly recorded. For purposes of an IRB approach, institutions that use expert and constrained judgment must record these factors and deliver them to the data warehouse.

For loss severity estimates, institutions must record the basic structural characteristics of facilities and the factors used in developing the facility rating or LGD estimate. These often include the seniority of the credit, the amount and type of collateral, the most recent collateral valuation date and its fair value.

Institutions must also track any overrides of the obligor or loss severity rating. Tracking overrides separately allows risk managers to identify whether the outcome of such overrides suggests either problems with rating criteria, or an improper level of discretion in adjusting the ratings.

Example Data Elements

For illustrative purposes, the following section provides examples of the kinds of data elements institutions will collect under an IRB data maintenance framework.

General descriptive obligor and facility data

The data below could be contained within a loan record or derived from various sources within the data warehouse. Guarantor data requirements are the same as for the obligor.

Obligor/Guarantor Data

- General data: name, address, industry
- ID number (unique for all related parent/sub relationships)
- Rating, date, and rater
- PD percentage corresponding to rating

General Facility Characteristics

- Facility amounts: committed, outstanding
- Facility type: Term, revolver, bullet, amortizing, etc.
- Purpose: acquisition, expansion, liquidity, inventory, working capital
- Covenants
- Facility ID number
- Origination and maturity dates
- Last renewal date
- Obligor ID link
- Rating, date and rater
- LGD dollar amount or percentage
- EAD dollar amount or percentage

Rating Assignment Data

The data below provide an example of the categories and types of data that institutions must retain in order to continually validate and improve rating systems. These data items should tie directly to the documented criteria that the institution employs in assigning ratings, both qualitative and quantitative. For example, rating criteria often include ranges of leverage or cash flow for a particular obligor rating. In addition, qualitative factors, such as management effectiveness can be recorded in numeric form. For example, a 1 may equate to exceptionally strong management, and a 5 to very weak. The rating data elements collected should be complete enough so that others can review the relevant factors driving the rating decisions.

Quantitative Factors in Obligor Ratings

- Asset and sale size
- Key ratios used within rating criteria:
—profitability,
—cash flow,
—leverage,
—liquidity, and
—other relevant factors.

Qualitative Factors in Obligor Ratings

- Quality of earnings and cash flow
- Management effectiveness, reliability
- Strategic direction, industry outlook, position
- Country factors and political risk
- Other relevant factors

External Factors in Obligor Ratings

- Public debt rating and trend
- External credit model score and trend

Rating Notations

- Flag for overrides or exceptions
- Authorized individual for changing rating

Key Facility Factors in LGD Ratings

- Seniority
- Collateral type: (cash, marketable securities, AR, stock, RE, etc.)
- Collateral value and valuation date
- Advance rates, LTV
- Industry
- Geography

Rating Notations

- Flag for overrides or exceptions
- Authorized individual for changing rating

Final Disposition Data

Only recently have institutions begun to collect more complete data about a loan's disposition. Many institutions maintain subsidiary systems for their problem credits with details recorded, at times manually, on systems that were not linked with the institution's central loan or risk management systems. The unlinked data are a significant hindrance in developing reliable PD, LGD, and EAD estimates.

In advanced systems, the "grave" portion of obligor and exposure tracking is an essential component for producing and validating risk estimates and is an important feedback mechanism for adjusting and improving risk estimates over time. Essential data elements are outlined below.

Obligor/Guarantor

- Default date
- Circumstances of default (for example, nonaccrual, bankruptcy chapters 7–11, nonpayment)

Facility

- Outstandings at default
- Amounts undrawn and outstanding plus time series prior to and through default

Disposition

- Amounts recovered and dates (including source: cash, collateral, guarantor, etc.)
- Collection cost and dates
- Discount factors to determine economic cost of collection
- Final disposition (for example, restructuring or sale)
- Sales price, if applicable
- Accounting items (charge-offs to date, purchased discounts)

C. Data Element Functions

S. Data elements must be of sufficient depth, scope, and reliability to:
- Validate IRB system processes,
- Validate parameters,
- Refine the IRB system,
- Develop internal parameter estimates,
- Apply improvements historically,
- Calculate capital ratios,
- Produce internal and public reports, and
- Support risk management.

Validation and Refinement

The data elements collected by institutions must be capable of meeting the validation requirements described in Chapters 1 and 2. These requirements include validating the institution's IRB system processes, including the ''front end'' aspects such as assigning ratings so that any issues can be identified early. The data must support efforts to identify whether raters and models are following rating criteria and policies and whether ratings are consistent across portfolios. In addition, data must support the validation of parameters, particularly the comparison of realized outcomes with estimates. Thorough data on default and disposition characteristics are of paramount importance for parameter back-testing.

A rich source of data for validation efforts provides insights on the performance of the IRB system, and contributes to a learning environment in which refinements can be made to the system. These potential refinements include enhancements to rating assignment controls, processes, criteria or model coefficients, rating system architecture and parameter estimates.

Developing Parameter Estimates

As detailed in Chapter 2, institutions will be developing their PD, LGD, and EAD parameter estimates using reference data sets comprised of internal, pooled, and external data. Institutions are expected to work toward eventually using as much of their own experience as possible in their reference data sets.

Applying Rating System Improvements Historically

For loss severity estimates, institutions must record the basic structural characteristics of facilities and the factors used in developing the facility rating or LGD estimate. These often include the seniority of the credit, the amount and type of collateral, the most recent collateral valuation date and its fair value.

To maintain a consistent series of information for credit risk monitoring and validation purposes, institutions need to be able to apply historically improvements they make to their rating systems. In the example below, a bank experiences unexpected and rapid migrations and defaults in its grade 4 category during 2006. Analysis of the actual financial condition of borrowers that defaulted compared with those that did not suggests the debt-to-EBITDA range for its expert judgment criteria of 3.0 to 5.5 is too broad. Research indicates that grade 4 should be redefined to include only borrowers with debt-to-EBITDA ratios of 3.0–4.5 and grade 5 as 4.5–6.5. In 2007, the change is initiated, but prior years' numbers are not recast (see Exhibit A). Consequently, a break in the series prevents the bank from evaluating credit quality changes over several years and from identifying whether applying the new rating criteria historically provides reasonable results.

Exhibit A (Revision of Grades 4 and 5 in 2007)

	Distribution of Obligor Risk Grades (%)					Change
	2004	2005	2006	2007	2008	04-'08
1	1	1.1	1.2	1.2	1.3	0.3
2	10	11	12	13	13	3.0
3	22	23	24	26	25	3.0
4	***30***	***30***	***32***	**16**	**17**	**(13.0)**
5	***20***	***21***	***19***	**33**	**34**	**14.0**
6	8	7	7	7	6	(2.0)
7	4	4	3	2	1	(3.0)
D	5	2.9	1.8	1.8	2.7	(2.3)
Total	100	100	100	100	100	0

Recognizing the need to provide senior managers and board members with a consistent risk trend, the new criteria are applied historically to obligors in grades 4 and 5 as reflected in Exhibit B. The original ratings assigned to the grades are maintained along with notations describing what the grade would be under the new rating criteria. If the precise weight an expert has given one of the redefined criteria is unknown, institutions are expected to make estimates on a best efforts basis. After the retroactive reallocation process, the bank observes that the mix of obligors in grade 5 declined somewhat over the past several years while the mix in grade 4 increased slightly. This contrasts with the trend identified before the retroactive reallocation. The result is that the multiyear transition statistics for grades 4 and 5 provide risk managers a clearer picture of risk.

Exhibit B (After Recasting 2004-06)

	Distribution of Obligor Risk Grades (%)					Change
	2004	2005	2006	2007	2008	04-'08
1	1	1.1	1.2	1.2	1.3	0.3
2	10	11	12	13	13	3.0
3	22	23	24	26	25	3.0
4	*16*	*15*	*16*	16	17	1.0
5	*35*	*36*	*35*	33	34	(1.0)
6	8	7	7	7	6	(2.0)
7	4	4	3	2	1	(3.0)
D	4	2.9	1.8	1.8	2.7	(1.3)
Total	100	100	100	100	100	0

This example is based on applying ratings historically using data already collected by the bank. However, for some rating system refinements, institutions may identify in the future drivers of default or loss that might not have been collected for borrowers or facilities in the past. That is why institutions are encouraged to collect data that they believe may serve as a stronger predictor of default in the future. For example, certain elements of a borrower's cash flow might currently be suspected to overstate actual operational health for a particular industry. In the future, should an institution decide to deduct this item from cash flow with a resulting downgrade of many obligor ratings, the institution that collected these data could apply this rating change for prior years. This would provide the benefit of providing a consistent picture of risk over time and also present opportunities to validate the new criteria using historical data. Recognizing that institutions will not be able to anticipate fully the data they might find useful in the future, institutions are expected to reallocate grades on a best efforts basis when practical.

Calculating Capital Ratios and Reporting to the Public

Data retained by the bank will be essential for regulatory risk-based capital calculations and public reporting under the Pillar 3 disclosures. These uses underscore the need for a well-defined data maintenance framework and strong controls over data integrity. Control processes and data elements themselves should also be subject to periodic verification and testing by internal and external auditors. Supervisors will rely on these processes and also perform testing as circumstances warrant.

Supporting Risk Management

The information that can be gleaned from more extensive data collection will support a broad range of risk management activities. Risk management functions will rely on accurate and timely data to track credit quality, make informed portfolio risk mitigation decisions, and perform portfolio stress tests. Trends developed from obligor and facility risk rating data will be used to support internal capital allocation models, pricing models, ALLL calculations, and performance management measures, among others. Summaries of these are included in reports to institutions' boards of directors, regulators, and in public disclosures.

D. Managing Data Quality and Integrity

Because data are collected at so many different stages involving a variety of groups and individuals, there are numerous challenges to ensuring the quality of the data. For example:

- Data will be retained over long timeframes,
- Qualitative risk-rating variables will have subjective elements and will be open to interpretation, and
- Exposures will be acquired through mergers and purchases, but without an adequate and easily retrievable institutional rating history.

Documentation and Definitions

S. Institutions must document the process for delivering, retaining and updating inputs to the data warehouse and ensuring data integrity.

Given the many challenges presented by data for an IRB system, the management of data must be formalized. Fully documenting how the institution's flow of data is managed provides a means for evaluating whether the data maintenance framework is functioning as intended. Moreover, institutions must be able to communicate to individuals developing or delivering various data the precise definition of the items intended to be collected. Consequently, a "data dictionary" is necessary to ensure consistent inputs from individuals and data vendors and to allow third parties (such as the rating system review function, auditors, or bank supervisors) to evaluate data quality and integrity.

S. Institutions must develop comprehensive definitions for the data elements used within each credit group or business line (a "data dictionary").

Electronic Storage

S. Institutions must store data in electronic format to allow timely retrieval for analysis, validation of risk rating systems, and required disclosures.

To meet the significant data management challenges presented by the validation and control features of an IRB system, institutions will need to store their data electronically. Institutions will have a variety of storage techniques and potentially a variety of systems to create their data warehouses. IRB data requirements can be achieved by melding together existing accounting, servicing, processing, workout and risk management systems, provided the linkages among these systems are well documented and include sufficient edit and integrity checks to ensure the data can be used reliably.

Institutions without electronic databases would need to resort to manual reviews of paper files for ongoing back-testing and ad hoc ''forensic'' data mining and would be unable to perform that work in the timely and comprehensive manner required of IRB systems. Forensic mining of paper files to build an initial data warehouse from the institution's credit history is encouraged. In some instances, paper research may be necessary to identify data elements or factors not originally considered significant in estimating the risk of a particular class of obligor or facility.

Data Gaps

Rating histories are often lost or are irretrievable for loans acquired through mergers, acquisitions, or portfolio purchases. Institutions are encouraged wherever practical to collect any missing historical rating assignment driver data and to re-grade the acquired obligors and facilities for prior periods. In cases where retrieving historical data is not practical, institutions may attempt to create a rating history through a careful mapping of the legacy system and the new rating structure. Mapped ratings should be reviewed thoroughly for accuracy. The level of effort placed on filling data gaps should be commensurate with the size of the new exposures to be newly incorporated into the institution's IRB system.

V. Control and Oversight Mechanisms

A. Overview

Banks' internal rating systems are the foundation for credit-risk management practices and play an important role in pricing, reserving, portfolio management, performance measurement, economic capital modeling, and long-term capital planning. Banks adopting the IRB approach will also use their credit-risk ratings to determine regulatory capital levels. The pivotal and varied uses of such risk ratings put enormous, sometimes conflicting, pressure on banks' internal rating systems. The consequences of inaccurate ratings and their associated estimates are significant, particularly as they affect minimum regulatory capital requirements.

As risk ratings and their related parameters become better integrated in institutions' decision making, conflicting incentives arise that, if not well managed, can lead to overly optimistic or biased ratings. For example, sales and marketing staff (relationship managers or RMs) are typically compensated according to the volume of business they generate. That may predispose the RMs to assign more favorable ratings in order to achieve rate-of-return and sales objectives. More favorable ratings may create the appearance of higher risk-adjusted returns and business line profitability. Banks need to be aware of the full range of incentive conflicts that arise, and must develop effective controls to keep these incentive conflicts in check.

Banks will have latitude in designing and implementing their control structures subject to the following principle:

IRB institutions must implement a system of controls that includes the following elements: independence, transparency, accountability, use of ratings, rating system review, internal audit, and board and senior management oversight. While banks will have flexibility in how these elements are combined, they must incorporate sufficient checks and balances to ensure that the credit risk management system is functioning properly.

Banks additionally will want to embody the following more generic principles in their control system: separation of duties, balancing incentives, and layers of review. Table 4.1 lists the key components of an IRB control and oversight system. How these control mechanisms can best be combined to reinforce one another is a key challenge for banks implementing IRB systems:

Table 4.1 Control and Oversight Mechanisms

Independence	The parties responsible for approving ratings and transactions should be separate from the sales and marketing staff and be principally compensated on risk-rating accuracy.
Transparency	The rating system and ratings should be sufficiently transparent to enable third parties, such as rating system reviewers, auditors and supervisors, the ability to understand the operations of the rating system and the rating rationale.
Accountability	Accountability is holding people responsible for their actions and establishing adverse consequences for inaccurate ratings.
Use of Ratings	Ratings should be used to guide day-to-day risk management activities.
Rating System Review	Ratings and rating system performance should be evaluated by an area independent of those responsible for assigning and approving ratings.
Internal Audit	Responsibility for ensuring the adequacy of control and oversight mechanisms and overall compliance with the IRB standards should rest with the internal audit function.
Board and Senior Management Oversight	Ultimate responsibility for the performance of the rating system rests with senior management and the board.

As the following examples indicate, how a bank conducts its business will influence how it designs its control structure. A bank using an expert-judgment system will likely establish a different set of controls than a bank using mainly models. Recognizing that its expert-judgment system is less than fully transparent, a bank could offset this vulnerability by opting for complete independence in the rating approval process and an enhanced rating system review.

Other considerations would influence the choice of controls when banks use models to assign ratings. While the ratings produced by models are transparent, a model's performance depends on how well the model was developed, the model's logic, and the quality of the data used to implement the model. Banks that use models to assign ratings must implement a system of controls that addresses model development, testing and implementation, data integrity and overrides. These activities would be covered by a comprehensive and independent rating system review and by ongoing spot checks on the accuracy of model inputs. Other control mechanisms such as accountability and audit would also be required.

B. Independence in the Rating Approval Process

An independent rating process is one in which the parties responsible for approving ratings and transactions are separate from sales and marketing and in which the persons approving ratings are principally compensated on risk-rating accuracy. As relative independence increases, the likelihood of accurate ratings assignments grows markedly.

S. Ratings must be subject to independent approval or review.

One way institutions can better achieve objective and accurate risk ratings is by ensuring that its rating approval process is independent. Institutions that firmly separate sales/marketing from credit are better able to manage the conflict between the goal of high sales volume and the need for good credit quality. An institution whose rating process is less independent must compensate by strengthening other control and oversight mechanisms. A significant factor in the evaluation of the rating system will be the assessment of whether such compensating controls are sufficient to offset a less-than-independent ratings process. While the overriding objective is to achieve independence in the rating approval process, in some instances, the relative materiality of a portfolio and cost/benefit trade-offs may support a less rigorous control process.

The degree of independence achieved in the rating process depends on how an institution is organized and how it conducts its lending activities.

Rating Approval Processes

Responsibility for recommending and approving ratings varies by institution and, quite often, by portfolio.[7] At some institutions, ratings are assigned and approved by relationship managers (RMs); at others, deal teams assign ratings that are later approved by credit officers. Still other institutions have independent credit officers assign and approve ratings. The culture of an institution and its business mix generally determine whether the business line or credit function is ultimately responsible for ratings.

The subsections that follow describe various rating assignment and approval structures used by banking organizations and the challenges that emerge in ensuring objective and consistent ratings. Any of the following structures can work as long as ratings are subject to an independent approval or review process, and are not unduly influenced by the line of business:

Relationship Managers. As noted earlier, relationship managers are primarily responsible for marketing the bank's products and services, and their compensation is tied to the volume of business they generate. When RMs also have responsibility for assigning and approving ratings, there is an inherent conflict of interest. Credit quality and the ability to produce timely and accurate risk ratings are generally not major factors in an RM's compensation, even when he or she has responsibility for assigning and approving ratings. In addition, RMs also may become too close to the borrower to maintain their objectivity and remain unbiased. When banks delegate rating responsibility to RMs, they must offset the lack of independence with rigorous controls to prevent bias from affecting the rating process. Such controls must operate in practice, not just on paper, and would include, at a minimum, a comprehensive, independent post-closing review of ratings by a rating system review function.

Deal Team. Some major banks employ a ''deal-team'' structure for credit origination and rating assignment. Using this approach, all members of the team—credit officers, investment bankers, underwriters, and others—contribute to analyzing creditworthiness, underwriting the deal, and assigning ratings.

On the one hand, deal teams increase the access of credit officers to information on obligors and transactions early in the underwriting process, enabling them to make more informed credit decisions and to influence facility structure to address obligors' weaknesses. On the other hand, participation in the deal team could compromise the credit officer's objectivity. While credit officers typically report to an independent credit-risk-management function, they also have allegiance to the deal team that reports to executives within the sales and marketing line of business. In addition, credit officers may defer to the members of the team whose compensation is based on the revenue and sales volume they generate for the bank. Banks that maintain deal teams must ensure that the credit officer's independence is safeguarded through independent reporting lines and well-defined performance measures (*e.g.*, adherence to policy, rating accuracy and timeliness).

Credit Officers. Some banks give sole responsibility for assigning and approving ratings to credit officers who report to an independent credit function. In addition to assigning and approving and assigning initial ratings, credit officers regularly monitor the condition of obligors and refresh ratings as necessary. The potential downside of this structure is that these credit officers may have limited access to borrower information. Those credit officers that have a separate reporting line and whose compensation is principally based on their risk-rating accuracy are typically more independent than RMs or deal teams.

Models. At some institutions, models assign ratings directly; at other institutions, models and judgment are combined to rate credits. Models introduce a high degree of independence to the rating process, but they too require human oversight and controls. Banks that use models must incorporate an independent judgmental review of the rating assignments to ensure that all relevant information is considered and to identify potential rating errors. Judgmental reviews are also needed when model outputs are

[7] Rating processes vary by institution but generally involve an ''assignor'' and an ''approver.'' For instance, at many organizations the rating assignor is the person who ''owns'' the relationship (such as a ''relationship manager'') and the rating approver is an individual with credit authority (a ''credit risk manager''). In some cases, the rating assignor and approver are the same. Banks that separate the rating assignment and approval processes do so in order to minimize potential conflicts of interest and the potential for rating errors.

overridden. In addition, controls are needed to ensure accuracy of data inputs. When a bank uses a model to assign risk ratings, an individual obligor's rating is ''transparent.'' However, the model itself is not ''transparent'' without a great deal of effort to document how the model functions.

C. Transparency

Transparency is the ability of a third party, such as rating system reviewers, auditors or bank supervisors, to observe how the rating system operates and to understand the pertinent characteristics of individual ratings.

S. IRB institutions must have a transparent rating system.

Transparency in a rating system is achieved through documentation that covers the following:

• The rating system's design, purpose, performance horizon, and performance standards;

• The rating assignment process, including procedures for adjustments and overrides;

• Rating definitions and criteria, scorecard criteria, and model specifications;

• Parameter estimates and the process for their estimation;

• Definition of the data elements to be warehoused to support controls, oversight, validation, and parameter estimation; and

• Specific responsibilities of, and performance standards for, individuals and units involved in the rating system and its oversight.

Transparency allows third parties (such as rating system review, auditors, or supervisors) to evaluate whether the rating system is performing as intended. Without transparency, it is difficult to hold people accountable for ratings errors and to validate the performance of the system.

S. Rating criteria must be clear and specific and must include qualitative and quantitative factors.

To produce transparent individual ratings, a bank's policies must contain clear, detailed ratings definitions. Banks should specify criteria for each factor that raters must consider, which may require unique rating definitions for certain industries. Banks should consider criteria for factors such as liquidity, sales and profitability, debt service and fixed charge coverage, minimum equity support, position within the industry, strength of management. A rating system with vague criteria or one merely defined by PDs or LGDs is not transparent. For example, the following rating definitions are not transparent because they require the rater to do too much interpreting:

Borrower exhibits satisfactory quality and demonstrates acceptable principal and interest repayment capacity in the near term.

Lower tier company in a cyclical industry. Unbalanced position with tight liquidity and high leverage. Declining or erratic profitability and marginal debt service capacity. Management is untested.

D. Accountability

''Accountability'' is holding people responsible for their actions and establishing adverse consequences for inaccurate ratings.

S. Policies must identify the parties responsible for rating accuracy and rating system performance.

For accountability to be effective, it should be both observable and ingrained in the culture. Persons who assign and approve rate credits, derive parameter estimates, or oversee rating systems must be held accountable for complying with rating system policies and ensuring that aspects of the rating system within their control are as unbiased and accurate as possible. These persons must have the tools and resources necessary to carry out their responsibilities, and their performance should be evaluated against clear and specific objectives documented in policy.

Responsibility for Assigning Ratings

S. Individuals must be held accountable for complying with rating system policies and for assigning accurate ratings, and their performance and compensation must be linked to well-defined measurable performance standards.

Responsibilities of raters should be clear, and performance should be measured against specific objectives. Performance evaluation and incentive compensation should be tied to performance goals. Examples of performance measures include:

• Number and frequency of rating errors,

• Significance of errors (for example, multiple downgrades), and

• Proper and consistent application of criteria, including override criteria.

Responsibility for Rating System Performance

Just as individuals will be held accountable for the accuracy of ratings, an individual must be held responsible for the overall performance of the rating system. This individual must ensure that the rating system and all of its component parts—rating assignments, parameter estimation, data collection, control and oversight mechanisms—are functioning as intended. While these components often are housed within separate units of the organization, an individual must be responsible for ensuring that the parts work together effectively and efficiently.

E. Use of Ratings

S. Ratings used for regulatory capital must be the same ratings used to guide day-to-day credit risk management activities.

The different uses and applications of the risk-rating system's outputs should promote greater accuracy and consistency of credit-risk evaluations across an organization. Ratings and the associated default, loss, and EAD estimates need to be incorporated within the credit-risk management, internal capital allocation, and corporate governance functions of IRB banks.

S. Banks that use parameter estimates for risk management that are different from those used for regulatory capital must provide a well-documented rationale for the differences.

PD and LGD parameters used for regulatory capital purposes may not be appropriate for other uses purposes. For example, PD estimates used to estimate reserve needs could reflect current economic conditions that are different from the longer term view appropriate to calculations of regulatory capital. When banks employ different estimates, those parameters must be defensible and supported by the following:

• Qualitative and quantitative analysis of the logic and rationale for the difference(s); and

• Senior management approval of the difference(s).

F. Rating System Review (RSR)

S. Banks must have a comprehensive, coordinated, independent review process to ensure that ratings are accurate and that the rating system is performing as intended.

Rating system review (RSR) ensures that the rating system as a whole is functioning as intended. A broad range of responsibilities come under RSR's purview, as outlined in Table 4.2:

TABLE 4.2.—RESPONSIBILITIES OF RATING SYSTEM REVIEW

Scope of Review:
Design of the rating system.
Compliance with policies and procedures, including application of criteria.
Check of all risk-rating grades for accuracy.
Consistency across industries/portfolios/geographies.

TABLE 4.2.—RESPONSIBILITIES OF RATING SYSTEM REVIEW—Continued

Model development.
Model use, including inputs and outputs.
Overrides and policy exceptions.
Quantification process.
Back-testing (perform or review).
Actual and predicted ratings transitions.
Benchmarking against third-party data sources (perform or review).
Adequacy of data maintenance.
Analysis and Reporting:
Identify errors and flaws.
Recommend corrective action.

For each of these responsibilities, RSR is largely checking and confirming the work of others and ensuring that the rating system's components work well together. RSR's testing and review should identify current and potential weaknesses and should lead to recommendations and corrective action such as

• Adjusting policies and procedures,
• Requiring additional training of staff,
• Investing in infrastructure improvements,
• Adjusting rating criteria, and
• Adjusting parameter estimates.

S. Rating system review must report significant findings to senior management and the board quarterly.

RSR's role is to identify issues and areas of concern and report findings to the area that is accountable. When issues are systematic, RSR should bring them to the attention of senior management and the board.

The activities of this function could be distributed across multiple areas or housed within one unit. Organizations will choose a structure that fits within their management and oversight framework. These units must always have high standing within the organization and should be staffed by individuals possessing the requisite stature, skills, and experience.

Like internal audit, RSR must be independent from all in-house designers and developers (that is, system and model designers) and raters (that is, ratings and parameter assigners) in the risk-rating process. RSR's independence eliminates potential conflicts of interest and gives the group credibility when it reports findings and conclusions to the board and senior management.

G. Internal Audit

S. An independent internal audit function must determine whether rating system controls function as intended.

S. Internal audit must evaluate annually whether the bank is in compliance with the risk-based capital regulation and supervisory guidance.

Internal audit determines whether the bank's system of controls over internal ratings and the related parameters is robust. In its evaluation of controls, internal audit must consider any trade-offs made between the various mechanisms and confirm their continued appropriateness and relevance. As part of its review of control mechanisms, audit will evaluate the depth, scope, and quality of RSR's work and will conduct limited testing to ensure that their conclusions are well founded. The amount of testing will depend on whether audit is the primary or secondary reviewer of that work.

Internal audit will report to the board and management on whether the bank is in compliance with the IRB standards. This report will allow the board and management to disclose that its rating processes and the controls surrounding these processes are in compliance with the IRB standards. This will be critical for public disclosure and ongoing work of supervisors.

External Audit

As part of the process of certifying financial statements, external auditors will confirm that the institution's capital position is fairly presented. To verify that actual capital exceeds regulatory minimums and to confirm compliance with the IRB rules, the external auditors must ascertain that the IRB system is rating credit risk appropriately and linking these ratings to appropriate estimates. Auditors must evaluate the bank's internal control functions and its compliance with the risk-based capital regulation and supervisory guidance.

H. Corporate Oversight

S. The full board or a committee of the board must approve key elements of the IRB system.

Consistent with sound practice, bank management must ensure that a corporate culture exists in which institutional needs are readily identified and appropriate resources are brought to bear to rectify shortcomings. In the IRB context, senior management and the board of directors must ensure the objectivity and accuracy of the bank's credit-risk management systems and approach.

Either the full board or a committee of the board should approve key elements of the risk-rating system. Information provided to the board should be sufficiently detailed to allow directors to confirm the continuing appropriateness of the institution's rating approach and to verify the adequacy of the controls supporting the rating system.

S. Senior management must ensure that all components of the IRB system, including controls, are functioning as intended and comply with the risk-based capital regulation and supervisory guidance.

Senior management's oversight should be even more active than that of the board of directors. Senior management should articulate what it expects of the technical and operational units of the risk-rating system, as well as what it expects of the units that manage the system's controls. To oversee the risk-rating system, senior management must have an extensive understanding of credit policies, underwriting standards, lending practices, and collection and recovery practices, and must be able to understand how these factors affect default and loss estimates. Senior management should not only oversee the controls process (its traditional role) but also should periodically meet with raters and validators to discuss the rating system's performance, areas needing improvement, and the status of efforts to improve previously identified deficiencies.

The depth and frequency of information provided to the board and senior management must be commensurate with their oversight responsibilities and the condition of the institution. These reports should include the following information:

• Risk profile by grade,
• Risk rating migration across grades with emphasis on unexpected results,
• Changes in parameter estimates by grade,
• Comparison of realized PD, LGD, and EAD rates against expectations,
• Reports measuring changes in regulatory and economic capital,
• Results of capital stress testing, and
• Reports generated by rating system review, audit, and other control units.

Although all of an institution's controls must function smoothly, independently, and in concert with the others, the direction and oversight provided by the board and senior management are perhaps most important to ensure that the IRB system is functioning properly.

Document 2: Draft Supervisory Guidance on Operational Risk Advanced Measurement Approaches for Regulatory Capital

Table of Contents

I. Purpose

The purpose of this guidance is to set forth the expectations of the U.S. banking agencies for banking institutions that use Advanced Measurement Approaches (AMA) for calculating the operational risk capital charge under the new capital regulation. Institutions using the AMA will have considerable flexibility to develop operational risk measurement systems appropriate to the nature of their activities, business environment, and internal controls. An institution's operational risk regulatory capital requirement will be calculated as the amount needed to cover its operational risk at a level of confidence determined by the supervisors, as discussed below. Use of an AMA is subject to supervisory approval.

This draft guidance should be considered with the advance notice of proposed rulemaking (ANPR) on revisions to the risk-based capital standard published elsewhere in today's **Federal Register**. As with the ANPR, the Agencies are seeking industry comment on this draft guidance. In addition to seeking comment on all specific aspects of this supervisory guidance, the Agencies are seeking comment on the extent to which the supervisory guidance strikes the appropriate balance between flexibility and specificity. Likewise, the Agencies are seeking comment on whether an appropriate balance has been struck between the regulatory requirements set forth in the ANPR and the supervisory standards set forth in this guidance.

II. Background

Effective management of operational risk is integral to the business of banking and to institutions' roles as financial intermediaries. Although operational risk is not a new risk, deregulation and globalization of financial services, together with the growing sophistication of financial technology, new business activities and delivery channels, are making institutions' operational risk profiles (*i.e.*, the level of operational risk across an institution's activities and risk categories) more complex.

This guidance identifies the supervisory standards (S) that institutions must meet and maintain to use an AMA for the regulatory capital charge for operational risk. The purpose of the standards is to provide the foundation for a sound operational risk framework, while allowing institutions to identify the most appropriate mechanisms to meet AMA requirements. Each institution will need to consider its complexity, range of products and services, organizational structure, and risk management culture as it develops its AMA. Operational risk governance processes need to be established on a firm-wide basis to identify, measure, monitor, and control operational risk in a manner comparable with the treatment of credit, interest rate, and market risks.

Institutions will be expected to develop a framework that measures and quantifies operational risk for regulatory capital purposes. To do this, institutions will need a systematic process for collecting operational risk loss data, assessing the risks within the institution, and adopting an analytical framework that translates the data and risk assessments into an operational risk exposure (see definition below). The analytical framework must incorporate a degree of conservatism that is appropriate for the overall robustness of the quantification process. Because institutions will be permitted to calculate their minimum regulatory capital on the basis of internal processes, the requirements for data capture, risk assessment, and the analytical framework described below are detailed and specific.

Effective operational risk measurement systems are built on both quantitative and qualitative risk assessment techniques. While the output of the regulatory framework for operational risk is a measure of exposure resulting in a capital number, the integrity of that estimate depends not only on the soundness of the measurement model, but also on the robustness of the institution's underlying risk management processes. In addition, supervisors view the introduction of the AMA as an important tool to further promote improvements in operational risk management and controls at large banking institutions.

This document provides both AMA supervisory standards and a discussion of how those standards should be incorporated into an operational risk framework. The relevant supervisory standards are listed at the beginning of each section and a full compilation of the standards is provided in Appendix A. Not every section has specific supervisory standards. When spanning more than one section, supervisory standards are listed only once.

Institutions will be required to meet, and remain in compliance with, all the supervisory standards to use an AMA framework. However, evaluating an institution's qualification with each of the individual supervisory standards will not be sufficient to determine an institution's overall readiness for AMA. Instead, supervisors and institutions must also evaluate how well the various components of an institution's AMA framework complement and reinforce one another to achieve the overall objectives of an accurate measure and effective management of operational risk. In performing their evaluation, supervisors will exercise considerable supervisory judgment, both in evaluating the individual components and the overall operational risk framework.

An institution's AMA methodology will be assessed as part of the ongoing supervision process. This will allow supervisors to incorporate existing supervisory efforts as much as possible into the AMA assessments. Some elements of operational risk (*e.g.*, internal controls and information technology) have long been subject to examination by supervisors. Where this is the case, supervisors will make every effort to leverage off these examination activities to assess the effectiveness of the AMA process. Substantive weaknesses identified in an examination will be factored into the AMA qualification process.

III. Definitions

There are important definitions that institutions must incorporate into an AMA framework. They are:

• *Operational risk:* The risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. The definition includes legal risk, which is the risk of loss resulting from failure to comply with laws as well as prudent ethical standards and contractual obligations. It also includes the exposure to litigation from all aspects of an institution's activities. The definition does not include strategic or reputational risks.[8]

• *Operational risk loss:* The financial impact associated with an operational event that is recorded in the institution's financial statements consistent with Generally Accepted Accounting Principles (GAAP). Financial impact includes all out-of-pocket expenses associated with an operational event but does not include opportunity costs, foregone revenue, or costs related to investment programs implemented to prevent subsequent operational risk losses. Operational risk losses are characterized by seven event factors associated with:

i. *Internal fraud:* An act of a type intended to defraud, misappropriate property or circumvent regulations, the law or company policy, excluding diversity/discrimination events, which involve at least one internal party.

ii. *External fraud:* An act of a type intended to defraud, misappropriate property or circumvent the law, by a third party.

iii. *Employment practices and workplace safety:* An act inconsistent with employment, health or safety laws or agreements, from payment of personal injury claims, or from diversity/discrimination events.

iv. *Clients, products, and business practices:* An unintentional or negligent failure to meet a professional obligation to specific clients (including fiduciary and suitability requirements), or from the nature or design of a product.

v. *Damage to physical assets:* The loss or damage to physical assets from natural disaster or other events.

vi. *Business disruption and system failures:* Disruption of business or system failures.

vii. *Execution, delivery, and process management:* Failed transaction processing or process management, from relations with trade counterparties and vendors.

• *Operational risk exposure:* An estimate of the potential operational losses that the banking institution faces at a soundness standard consistent with a 99.9 per cent confidence level over a one-year period. The institution will multiply the exposure by 12.5 to obtain risk-weighted assets for operational risk; this is added to the risk-weighted assets for credit and market risk to arrive at the denominator of the regulatory capital ratio.

• *Business environment and internal control factor assessments:* The range of tools that provide a meaningful assessment of the level and trends in operational risk across the institution. While the institution may use multiple tools in an AMA framework, they must all have the same objective of identifying key risks. There are a number of existing tools, such as audit scores and performance indicators that may be acceptable under this definition.

IV. Banking Activities and Operational Risk

The above definition of operational risk gives a sense of the breadth of exposure to operational risk that exists in banking today as well as the many interdependencies among risk factors that may result in an operational risk loss. Indeed, operational risk can occur in any activity, function, or unit of the institution.

The definition of operational risk incorporates the risks stemming from people, processes, systems and external events. People risk refers to the risk of management failure, organizational structure or other human resource failures. These risks may be exacerbated by poor training, inadequate controls, poor staffing resources, or other factors. The risk from processes stem from breakdowns in established processes, failure to follow processes, or inadequate process mapping within business lines. System risk covers instances of both disruption and outright system failures in both internal and outsourced operations. Finally, external events can include natural disasters, terrorism, and vandalism.

There are a number of areas where operational risks are emerging. These include:

• Greater use of automated technology has the potential to transform risks from manual processing errors to system failure risks, as greater reliance is placed on globally integrated systems;

• Proliferation of new and highly complex products;

• Growth of e-banking transactions and related business applications expose an institution to potential new risks (*e.g.*, internal and external fraud and system security issues);

• Large-scale acquisitions, mergers, and consolidations test the viability of new or newly integrated systems;

• Emergence of institutions acting as large-volume service providers create the need for continual maintenance of high-grade internal controls and back-up systems;

• Development and use of risk mitigation techniques (*e.g.*, collateral, insurance, credit derivatives, netting arrangements and asset securitizations) optimize an institution's exposure to market risk and credit risk, but potentially create other forms of risk (*e.g.*, legal risk); and

• Greater use of outsourcing arrangements and participation in clearing and settlement systems mitigate some risks while increasing others.

The range of banking activities and areas affected by operational risk must be fully identified and considered in the development of the institution's risk management and measurement plans. Since operational risk is not confined to particular business lines [9], product types, or organizational units, it should be managed in a consistent and comprehensive manner across the institution. Consequently, risk management mechanisms must encompass the full range of risks, as well as strategies that help to identify, measure, monitor and control those risks.

V. Corporate Governance

Supervisory Standards

S 1. The institution's operational risk framework must include an independent firm-wide operational risk management function, line of business management oversight, and independent testing and verification functions.

The management structure underlying an AMA operational risk framework may vary between institutions. However, within all AMA institutions, there are three key components that must be evident—the firm-wide operational risk management function, lines of business management, and the testing and verification function. These three elements are functionally independent [10] organizational components, but should work in cooperation to ensure a robust operational risk framework.

A. Board and Management Oversight

Supervisory Standards

S 2. The board of directors must oversee the development of the firm-wide operational risk framework, as

[8] An institution's definition of risk may encompass other risk elements as long as the supervisory definition is met.

[9] Throughout this guidance, terms such as "business units" and "business lines" are used interchangeably and refer not only to an institution's revenue-generating businesses, but also to corporate staff functions such as human resources or information technology.

[10] For the purposes of AMA, "functional independence" is defined as the ability to carry out work freely and objectively and render impartial and unbiased judgments. There should be appropriate independence between the firm-wide operational risk management functions, line of business management and staff and the testing/verification functions. Supervisory assessments of independence issues will rely upon existing regulatory guidance (*e.g.* audit, internal control systems, board of directors/management, etc.)

well as major changes to the framework. Management roles and accountability must be clearly established.

S 3. The board of directors and management must ensure that appropriate resources are allocated to support the operational risk framework.

The board is responsible for overseeing the establishment of the operational risk framework, but may delegate the responsibility for implementing the framework to management with the authority necessary to allow for its effective implementation. Other key responsibilities of the board include:

- Ensuring appropriate management responsibility, accountability and reporting;
- Understanding the major aspects of the institution's operational risk as a distinct risk category that should be managed;
- Reviewing periodic high-level reports on the institution's overall operational risk profile, which identify material risks and strategic implications for the institution;
- Overseeing significant changes to the operational risk framework; and
- Ensuring compliance with regulatory disclosure requirements.

Effective board and management oversight forms the cornerstone of an effective operational risk management process. The board and management have several broad responsibilities with respect to operational risk:

- To establish a framework for assessing operational risk exposure and identify the institution's tolerance for operational risk;
- To identify the senior managers who have the authority for managing operational risk;
- To monitor the institution's performance and overall operational risk profile, ensuring that it is maintained at prudent levels and is supported by adequate capital;
- To implement sound fundamental risk governance principles that facilitate the identification, measurement, monitoring, and control of operational risk;
- To devote adequate human and technical resources to operational risk management; and
- To institute remuneration policies that are consistent with the institution's appetite for risk and are sufficient to attract qualified operational risk management and staff.

Management should translate the operational risk management framework into specific policies, processes and procedures that can be implemented and verified within the institution's different business units. Communication of these elements will be essential to the understanding and consistent treatment of operational risk across the institution. While each level of management is responsible for effectively implementing the policies and procedures within its purview, senior management should clearly assign authority, responsibilities, and reporting relationships to encourage and maintain this accountability and ensure that the necessary resources are available to manage operational risk. Moreover, management should assess the appropriateness of the operational risk management oversight process in light of the risks inherent in a business unit's activities. The testing and verification function is responsible for completing timely and comprehensive assessments of the effectiveness of implementation of the institution's operational risk framework at the line of business and firm-wide levels.

Management collectively is also responsible for ensuring that the institution has qualified staff and sufficient resources to carry out the operational risk functions outlined in the operational risk framework. Additionally, management must communicate operational risk issues to appropriate staff that may not be directly involved in its management. Key management responsibilities include ensuring that:

- Operational risk management activities are conducted by qualified staff with the necessary experience, technical capabilities and access to adequate resources;
- Sufficient resources have been allocated to operational risk management, in the business lines as well as the independent firm-wide operational risk management function and verification areas, so as to sufficiently monitor and enforce compliance with the institution's operational risk policy and procedures; and
- Operational risk issues are effectively communicated with staff responsible for managing credit, market and other risks, as well as those responsible for purchasing insurance and managing third-party outsourcing arrangements.

B. Independent Firm-Wide Risk Management Function

Supervisory Standards

S 4. The institution must have an independent operational risk management function that is responsible for overseeing the operational risk framework at the firm level to ensure the development and consistent application of operational risk policies, processes, and procedures throughout the institution.

S 5. The firm-wide operational risk management function must ensure appropriate reporting of operational risk exposures and loss data to the board of directors and senior management.

The institution must have an independent firm-wide operational risk management function. The roles and responsibilities of the function will vary between institutions, but must be clearly documented. The independent firm-wide operational risk function should have organizational stature commensurate with the institution's operational risk profile, while remaining independent of the lines of business and the testing and verification function. At a minimum, the institution's independent firm-wide operational risk management function should ensure the development of policies, processes, and procedures that explicitly manage operational risk as a distinct risk to the institution's safety and soundness. These policies, processes and procedures should include principles for how operational risk is to be identified, measured, monitored, and controlled across the organization. Additionally, they should provide for the collection of the data needed to calculate the institution's operational risk exposure.

Additional responsibilities of the independent firm-wide operational risk management function include:

- Assisting in the implementation of the overall firm-wide operational risk framework;
- Reviewing the institution's progress towards stated operational risk objectives, goals and risk tolerances;
- Periodically reviewing the institution's operational risk framework to consider the loss experience, effects of external market changes, other environmental factors, and the potential for new or changing operational risks associated with new products, activities or systems. This review process should include an assessment of industry best practices for the institution's activities, systems and processes;
- Reviewing and analyzing operational risk data and reports; and
- Ensuring appropriate reporting to senior management and the board.

C. Line of Business Management

Supervisory Standards

S 6. Line of business management is responsible for the day-to-day management of operational risk within each business unit.

S 7. Line of business management must ensure that internal controls and practices within their line of business are consistent with firm-wide policies and procedures to support the management and measurement of the institution's operational risk.

Line of business management is responsible for both managing operational risk within the business lines and ensuring that policies and procedures are consistent with and support the firm-wide operational risk framework. Management should ensure that business-specific policies, processes, procedures and staff are in place to manage operational risk for all material products, activities, and processes. Implementation of the operational risk framework within each line of business should reflect the scope of that business and its inherent operational complexity and operational risk profile. Line of business management must be independent of both the firm-wide operational risk management and the testing and verification functions.

VI. Operational Risk Management Elements

The operational risk management framework provides the overall operational risk strategic direction and ensures that an effective operational risk management and measurement process is adopted throughout the institution. The framework should provide for the consistent application of operational risk policies and procedures throughout the institution and address the roles of both the independent firm-wide operational risk management function and the lines of business. The framework should also provide for the consistent and comprehensive capture of data elements needed to measure and verify the institution's operational risk exposure, as well as appropriate operational risk analytical frameworks, reporting systems, and mitigation strategies. The framework must also include independent testing and verification to assess the effectiveness of implementation of the institution's operational risk framework, including compliance with policies, processes, and procedures.

In practice, an institution's operational risk framework must reflect the scope and complexity of business lines, as well as the corporate organizational structure. Each institution's operational risk profile is unique and requires a tailored risk management approach appropriate for the scale and materiality of the risks present, and the size of the institution. There is no single framework that would suit every institution; different approaches will be needed for different institutions. In fact, many operational risk management techniques continue to evolve rapidly to keep pace with new technologies, business models and applications.

The key elements in the operational risk management process include:

- Appropriate policies and procedures;
- Efforts to identify and measure operational risk;
- Effective monitoring and reporting;
- A sound system of internal controls; and
- Appropriate testing and verification of the operational risk framework.

A. Operational Risk Policies and Procedures

Supervisory Standards

S 8. The institution must have policies and procedures that clearly describe the major elements of the operational risk management framework, including identifying, measuring, monitoring, and controlling operational risk.

Operational risk management policies, processes, and procedures should be documented and communicated to appropriate staff. The policies and procedures should outline all aspects of the institution's operational risk management framework, including:

- The roles and responsibilities of the independent firm-wide operational risk management function and line of business management;
- A definition for operational risk, including the loss event types that will be monitored;
- The capture and use of internal and external operational risk loss data, including large potential events (including the use of scenario analysis);
- The development and incorporation of business environment and internal control factor assessments into the operational risk framework;
- A description of the internally derived analytical framework that quantifies the operational risk exposure of the institution;
- An outline of the reporting framework and the type of data/information to be included in line of business and firm-wide reporting;
- A discussion of qualitative factors and risk mitigants and how they are incorporated into the operational risk framework;
- A discussion of the testing and verification processes and procedures;
- A discussion of other factors that affect the measurement of operational risk; and
- Provisions for the review and approval of significant policy and procedural exceptions.

B. Identification and Measurement of Operational Risk

The result of a comprehensive program to identify and measure operational risk is an assessment of the institution's operational risk exposure. Management must establish a process that identifies the nature and types of operational risk and their causes and resulting effects on the institution. Proper operational risk identification supports the reporting and maintenance of capital for operational risk exposure and events, facilitates the establishment of mechanisms to mitigate or control the risks, and ensures that management is fully aware of the sources of emerging operational risk loss events.

C. Monitoring and Reporting

Supervisory Standards

S 9. Operational risk management reports must address both firm-wide and line of business results. These reports must summarize operational risk exposure, loss experience, relevant business environment and internal control assessments, and must be produced no less often than quarterly.

S 10. Operational risk reports must also be provided periodically to senior management and the board of directors, summarizing relevant firm-wide operational risk information.

Ongoing monitoring of operational risk exposures is a key aspect of an effective operational risk framework. To facilitate monitoring of operational risk, results from the measurement system should be summarized in reports that can be used by the firm-wide operational risk and line of business management functions to understand, manage, and control operational risk and losses. These reports should serve as a basis for assessing operational risk and related mitigation strategies and creating incentives to improve operational risk management throughout the institution.

Operational risk management reports should summarize:

- Operational risk loss experience on an institution, line of business, and event-type basis;
- Operational risk exposure;
- Changes in relevant risk and control assessments;
- Management assessment of early warning factors signaling an increased risk of future losses;
- Trend analysis, allowing line of business and independent firm-wide operational risk management to assess

and manage operational risk exposures, systemic line of business risk issues, and other corporate risk issues;

- Exception reporting; and
- To the extent developed, operational risk causal factors.

High-level operational risk reports must also be produced periodically for the board and senior management. These reports must provide information regarding the operational risk profile of the institution, including the sources of material risk both from a firm-wide and line of business perspective, versus established management expectations.

D. Internal Control Environment

Supervisory Standards

S 11. An institution's internal control structure must meet or exceed minimum regulatory standards established by the Agencies.

Sound internal controls are essential to an institution's management of operational risk and are one of the foundations of safe and sound banking. When properly designed and consistently enforced, a sound system of internal controls will help management safeguard the institution's resources, produce reliable financial reports, and comply with laws and regulations. Sound internal controls will also reduce the possibility of significant human errors and irregularities in internal processes and systems, and will assist in their timely detection when they do occur.

The Agencies are not introducing any new internal control standards, but rather emphasizing the importance of meeting existing standards. There is a recognition that internal control systems will differ among institutions due to the nature and complexity of an institution's products and services, organizational structure, and risk management culture. The AMA standards allows for these differences, while also establishing a baseline standard for the quality of the internal control structure. Institutions will be expected to at least meet the minimum interagency standards[11] relating to internal controls as a criterion for AMA qualification.

The extent to which an institution meets or exceeds the minimum standards will primarily be assessed through current and ongoing supervisory processes. As noted earlier, the Agencies will leverage off existing examination processes, to avoid duplication in assessing an institution's implementation of an AMA framework. Assessing the internal control environment is clearly an area where the supervisory authorities already focus considerable attention.

VII. Elements of an AMA Framework

Supervisory Standards

S 12. The institution must demonstrate that it has appropriate internal loss event data, relevant external loss event data, assessments of business environment and internal controls factors, and results from scenario analysis to support its operational risk management and measurement framework.

S 13. The institution must include the regulatory definition of operational risk as the baseline for capturing the elements of the AMA framework and determining its operational risk exposure.

S 14. The institution must have clear standards for the collection and modification of the elements of the operational risk AMA framework.

Operational risk inputs play a significant role in both the management and measurement of operational risk. Necessary elements of an institution's AMA framework include internal loss event data, relevant external loss event data, results of scenario analysis, and assessments of the institution's business environment and internal controls. Operational risk inputs aid the institution in identifying the level and trend of operational risk, determining the effectiveness of risk management and control efforts, highlighting opportunities to better mitigate operational risk, and assessing operational risk on a forward-looking basis.

To use its AMA framework, an institution must demonstrate that it has established a consistent and comprehensive process for the capture of all elements of the AMA framework. The institution must also demonstrate that it has clear standards for the collection and modification of all AMA inputs. While the analytical framework will generally combine these inputs to develop the operational risk exposure, supervisors must have the capacity to review the individual inputs as well; specifically, supervisors will need to review the loss information that is being provided to the analytical framework that stems from internal loss event data, versus the loss event information provided by external loss event data capture, scenario analysis, or the assessments of the business environment and internal control factors.

The capture systems must cover all material business lines, business activities and corporate functions that could generate operational risk. The institution must have a defined process that establishes responsibilities over the systems developed to capture the AMA elements. In particular, the issue of overriding the data capture systems must be addressed. Any overrides should be tracked separately and documented. Tracking overrides separately allows management and supervisors to identify the nature and rationale, including whether they stem from simple input errors or, more importantly, from exclusion because a loss event was not pertinent for the quantitative measurement. Management should have clear standards for addressing overrides and should clearly delineate who has authority to override the data systems and under what circumstances.

As noted earlier, for AMA qualification purposes, an institution's operational risk framework must, at a minimum, use the definition of operational risk that is provided in paragraph 10 when capturing the elements of the AMA framework. Institutions may use an expanded definition if considered more appropriate for risk management and measurement efforts. However, for the quantification of operational risk exposure for regulatory capital purposes, an institution must demonstrate that the AMA elements are captured so as to meet the baseline definition.

A. Internal Operational Risk Loss Event Data

Supervisory Standards

S 15. The institution must have at least five years of internal operational risk loss data[12] captured across all material business lines, events, product types, and geographic locations.

S 16. The institution must be able to map internal operational risk losses to the seven loss-event type categories.

S 17. The institution must have a policy that identifies when an operational risk loss becomes a loss event and must be added to the loss

[11] There are a number of interagency standards that cover topics relevant to the internal control structure. These include, for example, the Interagency Policy Statement on the Internal Audit Function and Its Outsourcing (March 2003), the Federal Financial Institution's Examination Council's (FFIEC's) Business Continuity Planning Booklet (May 2003), the FFIEC's Information Security Booklet (January 2003). In addition, each Agency has extensive guidance on corporate governance, internal controls, and monitoring and reporting in its respective examination policies and procedures.

[12] With supervisory approval, a shorter initial historical observation period is acceptable for banks newly authorized to use an AMA methodology.

event database. The policy must provide for consistent treatment across the institution.

S 18. The institution must establish appropriate operational risk data thresholds.

S 19. Losses that have any characteristics of credit risk, including fraud-related credit losses, must be treated as credit risk for regulatory capital purposes. The institution must have a clear policy that allows for the consistent treatment of loss event classifications (*e.g.*, credit, market, or operational risk) across the organization.

The key to internal data integrity is the consistency and completeness with which loss event data capture processes are implemented across the institution. Management must ensure that operational risk loss event information captured is consistent across the business lines and incorporates any corporate functions that may also experience operational risk events. Policies and procedures should be addressed to the appropriate staff to ensure that there is satisfactory understanding of operational risk and the data capture requirements under the operational risk framework. Further, the independent operational risk management function must ensure that the loss data is captured across all material business lines, products types, event types, and from all significant geographic locations. The institution must be able to capture and aggregate internal losses that cross multiple business lines or event types. If data is not captured across all business lines or from all geographic locations, the institution must document and explain the exceptions.

AMA institutions must be able to map operational risk losses into the seven loss event categories defined in paragraph 10. Institutions will not be required to produce reports or perform analysis for internal purposes on the basis of the loss event categories, but will be expected to use the information about the event-type categories as a check on the comprehensiveness of the institution's data set.

The institution must have five years of internal loss data, although a shorter range of historical data may be allowed, subject to supervisory approval. The extent to which an institution collects operational risk loss event data will, in part, be dependent upon the data thresholds that the institution establishes. There are a number of standards that an institution may use to establish the thresholds. They may be based on product types, business lines, geographic location, or other appropriate factors. The Agencies will allow flexibility in this area, provided the institution can demonstrate that the thresholds are reasonable, do not exclude important loss events, and capture a significant proportion of the institution's operational risk losses.

The institution must capture comprehensive data on all loss events above its established threshold level. Aside from information on the gross loss amount, the institution should collect information about the date of the event, any recoveries, and descriptive information about the drivers or causes of the loss event. The level of detail of any descriptive information should be commensurate with the size of the gross loss amount. Examples of the type of information collected include:

• Loss amount;
• Description of loss event;
• Where the loss is reported and expensed;
• Loss event type category;
• Date of the loss;
• Discovery date of the loss;
• Event end date;
• Management actions;
• Insurance recoveries;
• Other recoveries; and
• Adjustments to the loss estimate.

There are a number of additional data elements that may be captured. It may be appropriate, for example, to capture data on ''near miss'' events, where no financial loss was incurred. These near misses will not factor into the regulatory capital calculation, but may be useful for the operational risk management process.

Institutions will also be permitted and encouraged to capture loss events in their operational risk databases that are treated as credit risk for regulatory capital purposes, but have an underlying element of operational risk failure. These types of events, while not incorporated into the regulatory capital calculation, may have implications for operational risk management. It will be essential for institutions that capture loss events that are treated differently for regulatory capital and management purposes to demonstrate that (1) loss events are being captured consistently across the institution; (2) the data systems are sufficiently advanced to allow for this differential treatment of loss events; and (3) credit, market, and operational risk losses are being appropriated in the correct manner for regulatory capital purposes.

The Agencies have established a clear boundary between credit and operational risks for regulatory capital purposes. If a loss event has any element of credit risk, it must be treated as credit risk for regulatory capital purposes. This would include all credit-related fraud losses. In addition, operational risk losses with credit risk characteristics that have historically been included in institutions' credit risk databases will continue to be treated as credit risk for the purposes of calculating minimum regulatory capital.

The accounting guidance for credit losses provides that creditors recognize credit losses when it is probable that they will be unable to collect all amounts due according to the contractual terms of a loan agreement. Credit losses may result from the creditor's own underwriting, processing, servicing or administrative activities along with the borrower's failure to pay according to the terms of the loan agreement. While the creditor's personnel, systems, policies or procedures may affect the timing or magnitude of a credit loss, they do not change its character from credit to operational risk loss for regulatory capital purposes. Losses that arise from a contractual relationship between a creditor and a borrower are credit losses whereas losses that arise outside of a relationship between a creditor and a borrower are operational losses.

B. External Data

Supervisory Standards

S 20. The institution must have policies and procedures that provide for the use of external loss data in the operational risk framework.

S 21. Management must systematically review external data to ensure an understanding of industry experience.

External data may serve a number of different purposes in the operational risk framework. Where internal loss data is limited, external data may be a useful input in determining the institution's level of operational risk exposure. Even where external loss data is not an explicit input to an institution's data set, such data provides a means for the institution to understand industry experience, and in turn, provides a means for assessing the adequacy of its internal data. External data may also prove useful to inform scenario analysis, fit severity distributions, or benchmark the overall operational risk exposure results.

To incorporate external loss information into an institution's framework, the institution should collect the following information:

• External loss amount;
• External loss description;
• Loss event type category;
• External loss event date;
• Adjustments to the loss amount (*i.e.,* recoveries, insurance settlements,

etc) to the extent that they are known; and

• Sufficient information about the reporting institution to facilitate comparison to its own organization.

Institutions may obtain external loss data in any reasonable manner. There are many ways to do so; some institutions are using data acquired through membership with industry consortia while other institutions are using data obtained from vendor databases or public sources such as court records or media reports. In all cases, management will need to carefully evaluate the data source to ensure that they are comfortable that the information being reported is relevant and reasonably accurate.

C. Business Environment and Internal Control Factor Assessments

Supervisory Standards

S 22. The institution must have a system to identify and assess business environment and internal control factors.

S 23. Management must periodically compare the results of their business environment and internal control factor assessments against actual operational risk loss experience.

While internal and external loss data provide a historical perspective on operational risk, it is also important that institutions incorporate a forward-looking element to the operational risk measure. In principle, an institution with strong internal controls in a stable business environment will have less exposure to operational risk than an institution with internal control weaknesses that is growing rapidly or introducing new products. In this regard, institutions will be required to identify the level and trends in operational risk in the institution. These assessments must be current, comprehensive across the institution, and identify the critical operational risks facing the institution.

The business environment and internal control factor assessments should reflect both the positive and negative trends in risk management within the institution as well as changes in an institution's business activities that increase or decrease risk. Because the results of the risk assessment are part of the capital methodology, management must ensure that the risk assessments are done appropriately and reflect the risks of the institution. Periodic comparisons should be made between actual loss exposure and the assessment results.

The framework established to maintain the risk assessments must be sufficiently flexible to encompass an institution's increased complexity of activities, new activities, changes in internal control systems, or an increased volume of information.

D. Scenario Analysis

Supervisory Standards

S 24. Management must have policies and procedures that identify how scenario analysis will be incorporated into the operational risk framework.

Scenario analysis is a systematic process of obtaining expert opinions from business managers and risk management experts to derive reasoned assessments of the likelihood and impact of plausible operational losses consistent with the regulatory soundness standard. Within an institution's operational risk framework, scenario analysis may be used as an input or may, as discussed below, form the basis of an operational risk analytical framework.

As an input to the institution's framework, scenario analysis is especially relevant for business lines or loss event types where internal data, external data, and assessments of the business environment and internal control factors do not provide a sufficiently robust estimate of the institution's exposure to operational risk. In some cases, an institution's internal loss history may be sufficient to provide a reasonable estimate of exposure to future operational losses. In other cases, the use of well-reasoned, scaled external data may itself be a form of scenario analysis.

The institution must have policies and procedures that define scenario analysis and identify its role in the operational risk framework. The policy should cover key elements of scenario analysis, such as the manner in which the scenarios are generated, the frequency with which they are updated, and the scope and coverage of operational loss events they are intended to reflect.

VIII. Risk Quantification

A. Analytical Framework

Supervisory Standards

S 25. The institution must have a comprehensive operational risk analytical framework that provides an estimate of the institution's operational risk exposure, which is the aggregate operational loss that it faces over a one-year period at a soundness standard consistent with a 99.9 per cent confidence level.

S 26. Management must document the rationale for all assumptions underpinning its chosen analytical framework, including the choice of inputs, distributional assumptions, and the weighting across qualitative and quantitative elements. Management must also document and justify any subsequent changes to these assumptions.

S 27. The institution's operational risk analytical framework must use a combination of internal operational loss event data, relevant external operational loss event data, business environment and internal control factor assessments, and scenario analysis. The institution must combine these elements in a manner that most effectively enables it to quantify its operational risk exposure. The institution can choose the analytical framework that is most appropriate to its business model.

S 28. The institution's capital requirement for operational risk will be the sum of expected and unexpected losses unless the institution can demonstrate, consistent with supervisory standards, the expected loss offset.

The industry has made significant progress in recent years in developing analytical frameworks to quantify operational risk. The analytical frameworks, which are a part of the overall operational risk framework, are based on various combinations of an institution's own operational loss experience, the industry's operational loss experience, the size and scope of the institution's activities, the quality of the institution's control environment, and management's expert judgment. Because these models capture specific characteristics of each institution, such models yield unique risk-sensitive estimates of the institutions' operational risk exposures.

While the Agencies are not specifying the exact methodology that an institution should use to determine its operational risk exposure, minimum supervisory standards for acceptable approaches have been developed. These standards have been set so as to assure that the regulation can accommodate continued evolution of operational risk quantification techniques, yet remain amenable to consistent application and enforcement across institutions. The Agencies will require that the institution have a comprehensive analytical framework that provides an estimate of the aggregate operational loss that it faces over a one-year period at a soundness standard consistent with a 99.9 percent confidence level, referred to as the institution's operational risk exposure. The institution will multiply the exposure estimate by 12.5 to obtain risk weighted assets for operational risk, and add this figure to risk-weighted assets for credit and market risk to obtain total risk-weighted assets. The final minimum regulatory capital number will be 8 percent of total risk-weighted assets.

The Agencies expect that there will be significant variation in analytical frameworks across institutions, with each institution tailoring its framework to leverage existing technology platforms and risk management procedures. These approaches may only be used, provided they meet the supervisory standards and include, as inputs, internal operational loss event data, relevant external operational loss event data, assessments of business environment and internal control factors, and scenario analysis. The Agencies do expect that there will be some uncertainty and potential error in the analytical frameworks because of the evolving nature of operational risk measurement and data capture. Therefore, a degree of conservatism will need to be built into the analytical frameworks to reflect the evolutionary status of operational risk and its impact on data capture and analytical modeling.

A diversity of analytical approaches is emerging in the industry, combining and weighting these inputs in different ways. Most current approaches seek to estimate loss frequency and loss severity to arrive at an aggregate loss distribution. Institutions then use the aggregate loss distribution to determine the appropriate amount of capital to hold for a given soundness standard. Scenario analysis is also being used by many institutions, albeit to significantly varying degrees. Some institutions are using scenario analysis as the basis for their analytical framework, while others are incorporating scenarios as a means for considering the possible impact of significant operational losses on their overall operational risk exposure.

The primary differences among approaches being used today relate to the weight that institutions place on each input. For example, institutions with comprehensive internal data may place less emphasis on external data or scenario analysis. Another example is that some institutions estimate a unique loss distribution for each business line/loss type combination (bottom-up approach) while others estimate a loss distribution on a firm-wide basis and then use an allocation methodology to assign capital to business lines (top-down approach).

The Agencies expect internal loss event data to play an important role in the institution's analytical framework, hence the requirement for five years of internal operational risk loss data. However, as footnote 5 makes clear, five years of data is not always required for the analytical framework. For example, if a bank exited a business line, the institution would not be expected to make use of that business unit's loss experience unless it had relevance for other activities of the institution. Another example would be where a bank has made a recent acquisition where the acquired firm does not have internal loss event data. In these cases, the Agencies expect the institution to make use of the loss data available at the acquired institution and any internal loss data from operations similar to that of the acquired firm, but the institution will likely have to place more weight relevant external loss event data, results from scenario analysis, and factors reflecting assessments of the business environment and internal controls.

Whatever analytical approach an institution chooses, it must document and provide the rationale for all assumptions embedded in its chosen analytical framework, including the choice of inputs, distributional assumptions, and the weighting of qualitative and quantitative elements. Management must also document and justify any subsequent changes to these assumptions. This documentation should:

- Clearly identify how the different inputs are combined and weighted to arrive at the overall operational risk exposure so that the analytical framework is transparent. The documentation should demonstrate that the analytical framework is comprehensive and internally consistent. Comprehensiveness means that all required inputs are incorporated and appropriately weighted. At the same time, there should not be overlaps or double counting.
- Clearly identify the quantitative assumptions embedded in the methodology and provide explanation for the choice of these assumptions. Examples of quantitative assumptions include distributional assumptions about frequency and severity, the methodology for combining frequency and severity to arrive at the overall loss distribution, and dependence assumptions between operational losses across and within business lines.
- Clearly identify the qualitative assumptions embedded in the methodology and provide explanations for the choice of these assumptions. Examples of qualitative assumptions include the use of business environment and control factors as well as scenario analysis in the approach.
- Where feasible, provide results based purely on quantitative methods separately from results that incorporate qualitative factors. This will provide a transparent means of determining the relative importance of quantitative versus qualitative inputs.
- Where feasible, provide results based on alternative quantitative and qualitative assumptions to gauge the overall model's sensitivity to these assumptions.
- Provide a comparison of the operational risk exposure estimate generated by the analytical framework with actual loss experience over time, to assess the reasonable of the framework's outputs.
- Clearly identify all changes to assumptions, and provide explanations for such changes.
- Clearly identify the results of an independent verification of the analytical framework.

The regulatory capital charge for operational risk will include both expected losses (EL) and unexpected losses (UL). The Agencies have considered two approaches that might allow for some recognition of EL; these approaches are reserving and budgeting. However, both approaches raise questions about their ability to act as an EL offset for regulatory capital purposes. The current U.S. GAAP treatment for reserves (or liabilities) is based on an incurred-loss (liability) model. Given that EL is looking beyond current losses to losses that will be incurred in the future, establishing a reserve for operational risk EL is not likely to meet U.S. accounting standards. While reserves are specific allocations for incurred losses, budgeting is a process of generally allocating future income for loss contingencies, including losses resulting from operational risk. Institutions will be required to demonstrate that budgeted funds are sufficiently capital-like and remain available to cover EL over the next year. In addition, an institution will not be permitted to recognize EL offsets on budgeted loss contingencies that fall below the established data thresholds; this is relevant as many institutions currently budget for low severity, high frequency events that are more likely to fall below most institutions' thresholds.

An institution's analytical framework complements but does not substitute for prudent controls. Rather, with improved risk measurement, institutions are finding that they can make better-informed strategic decisions regarding enhancements to controls and processes, the desired scale and scope of the operations, and how insurance and other risk mitigation tools can be used to offset operational risk exposure.

B. Accounting for Dependence

Supervisory Standards

S 29. Management must document how its chosen analytical framework accounts for dependence (*e.g.*, correlations) among operational losses across and within business lines. The institution must demonstrate that its explicit and embedded dependence assumptions are appropriate, and where dependence assumptions are uncertain, the institution must use conservative estimates.

Management must document how its chosen analytical framework accounts for dependence (*e.g.*, correlation) between operational losses across and within business lines. The issue of dependence is closely related to the choice between a bottom-up or a top-down modeling approach. Under a bottom-up approach, explicit assumptions regarding cross-event dependence are required to estimate operational risk exposure at the firm-wide level. Management must demonstrate that these assumptions are appropriate and reflect the institution's current environment. If the dependence assumptions are uncertain, the institution must choose conservative estimates. In so doing, the institution should consider the possibility that cross-event dependence may not be constant, and may increase during stress environments.

Under a top-down approach, an explicit assumption regarding dependence is not required. However, a parametric distribution for loss severity may be more difficult to specify under the top-down approach, as it is a statistical mixture of (potentially) heterogeneous business line and event type distributions. Institutions must carefully consider the conditions necessary for the validity of top-down approaches, and whether these conditions are met in their particular circumstances. Similar to bottom-up approaches, institutions using top-down approaches must ensure that implicit dependence assumptions are appropriate and reflect the institution's current environment. If historic dependence assumptions embedded in top-down approaches are uncertain, the institution must be conservative and implement a qualitative adjustment to the analysis.

IX. Risk Mitigation

Supervisory Standards

S 30. Institutions may reduce their operational risk exposure results by no more than 20% to reflect the impact of risk mitigants. Institutions must demonstrate that mitigation products are sufficiently capital-like to warrant inclusion in the adjustment to the operational risk exposure.

There are many mechanisms to manage operational risk, including risk transfer through risk mitigation products. Because risk mitigation can be an important element in limiting or reducing operational risk exposure in an institution, an adjustment is being permitted that will directly impact the amount of regulatory capital that is held for operational risk. The adjustment is limited to 20% of the overall operational risk exposure result determined by the institution using its loss data, qualitative factors, and quantitative framework.

Currently, the primary risk mitigant used for operational risk is insurance. There has been discussion that some securities products may be developed to provide risk mitigation benefits; however, to date, no specific products have emerged that have characteristics sufficient to be considered capital-replacement for operational risk. As a result, securities products and other capital market instruments may not be factored in to the regulatory capital risk mitigation adjustment at this time.

For an institution that wishes to adjust its regulatory capital requirement as a result of the risk mitigating impact of insurance, management must demonstrate that the insurance policy is sufficiently capital-like to provide the cushion that is necessary. A product that would fall in this category must have the following characteristics:

- The policy is provided through a third party [13] that has a minimum claims paying ability rating of A; [14]
- The policy has an initial term of one year; [15]
- The policy has no exclusions or limitations based upon regulatory action or for the receiver or liquidator of a failed bank;
- The policy has clear cancellation and non-renewal notice periods; and
- The policy coverage has been explicitly mapped to actual operational risk exposure of the institution.

Insurance policies that meet these standards may be incorporated into an institution's adjustment for risk mitigation. An institution should be conservative in its recognition of such policies, for example, the institution must also demonstrate that insurance policies used as the basis for the adjustment have a history of timely payouts. If claims have not been paid on a timely basis, the institution must exclude that policy from the operational risk capital adjustment. In addition, the institution must be able to show that the policy would actually be used in the event of a loss situation; that is, the deductible may not be set so high that no loss would ever conceivably exceed the deductible threshold.

The Agencies will not specify how institutions should calculate the risk mitigation adjustment. Nevertheless, institutions are expected to use conservative assumptions when calculating adjustments. An institution should discount (*i.e.,* apply its own estimates of haircuts) the impact of insurance coverage to take into account factors, which may limit the likelihood or size of claims payouts. Among these factors are the remaining terms of a policy, especially when it is less than a year, the willingness and ability of the insurer to pay on a claim in a timely manner, the legal risk that a claim may be disputed, and the possibility that a policy can be cancelled before the contractual expiration.

X. Data Maintenance

Supervisory Standards

S 31. Institutions using the AMA approach for regulatory capital purposes must use advanced data management practices to produce credible and reliable operational risk estimates.

Data maintenance is a critical factor in an institution's operational risk framework. Institutions with advanced data management practices should be able to track operational risk loss events from initial discovery through final resolution. These institutions should also be able to make appropriate adjustments to the data and use the data to identify trends, track problem areas, and identify areas of future risk. Such data should include not only operational risk loss event information, but also information on risk assessments, which are factored into the operational risk exposure calculation. In general, institutions using the AMA

[13] Where operational risk is transferred to a captive or an affiliated insurer such that risk is retained within the group structure, recognition of such risk transfer will only be allowed for regulatory capital purposes where the risk has been transferred to a third party (*e.g.,* an unaffiliated reinsurer) that meets the standards set forth in this section.

[14] Rating agencies may use slightly different rating scales.For the purpose of this supervisory guidance, the insurer must have a rating that is at least the equivalent of A under Standard and Poor's Insurer Financial Strength Ratings or an A2 under Moody's Insurance Financial Strength Ratings.

[15] Institutions must decrease the amount of the adjustment if the remaining term is less than one year. The institution must have a clear policy in place that links the remaining term to the adjustment factor.

should have the same data maintenance standards for operational risk as those set forth for A–IRB institutions under the credit risk guidance.

Operational risk data elements captured by the institution must be of sufficient depth, scope, and reliability to:

- Track and identify operational risk loss events across all business lines, including when a loss event impacts multiple business lines.
- Calculate capital ratios based on operational risk exposure results. The institution must also be able to factor in adjustments related to risk mitigation, correlations, and risk assessments.
- Produce internal and public reports on operational risk measurement and management results, including trends revealed by loss data and/or risk assessments. The institution must also have sufficient data to produce exception reports for management.
- Support risk management activities.

The data warehouse [16] 16 must contain the key data elements needed for operational risk measurement, management, and verification. The precise data elements may vary by institution and also among business lines within an institution. An important element of ensuring consistent reporting of the data elements is to develop comprehensive definitions for each data element used by the institution for reporting operational risk loss events or for the risk assessment inputs. The data must be stored in an electronic format to allow for timely retrieval for analysis, verification and testing of the operational risk framework, and required disclosures.

Management will need to identify those responsible for maintaining the data warehouse. In particular, policies and processes will need to be developed for delivering, storing, retaining, and updating the data warehouse. Policies and procedures must also cover the edit checks for data input functions, as well as the requirements for the testing and verification function to verify data integrity. Like other areas of the operational risk framework, it is critical that management ensure accountability for ongoing data maintenance, as this will impact operational risk management and measurement efforts.

XI. Testing and Verification

Supervisory Standards

S 32. The institution must test and verify the accuracy and appropriateness of the operational risk framework and results.

S 33. Testing and verification must be done independently of the firm-wide operational risk management function and the institution's lines of business.

The operational risk framework must provide for regular and independent testing and verification of operational risk management policies, processes and measurement systems, as well as operational risk data capture systems. For most institutions, operational risk verification and testing will primarily be done by the audit function. Internal and external audits can provide an independent assessment of the quality and effectiveness of the control systems' design and performance. However, institutions may use other independent internal units (*e.g.* quality assurance) or third parties. The testing and verification function, whether internally or externally performed, should be staffed by qualified individuals who are independent from the firm-wide operational risk management function and the institution's lines of business.

The verification of the operational risk measurement system should include the testing of:

- Key operational risk processes and systems;
- Data feeds and processes associated with the operational risk measurement system;
- Adjustments to empirical operational risk capital estimates, including operational risk exposure;
- Periodic certification of operational risk models used and their underlying assumptions; and
- Assumptions underlying operational risk exposure, data decision models, and operational risk capital charge.

The operational risk reporting processes should be periodically reviewed for scope and effectiveness. The institution should have independent verification processes to ensure the timeliness, accuracy, and comprehensiveness of operational risk reporting systems, both at the firm-wide and the line of business levels.

Independent verification and testing should be done to ensure the integrity and applicability of the operational risk framework, operational risk exposure/loss data, and the underlying assumptions driving the regulatory capital measurement process. Appropriate reports, summarizing operational risk verification and testing findings for both the independent firm-wide risk management function and lines of business should be provided to appropriate management and the board of directors or a designated board committee.

Appendix A: Supervisory Standards for the AMA

S 1. The institution's operational risk framework must include an independent firm-wide operational risk management function, line of business management oversight, and independent testing and verification functions.

S 2. The board of directors must oversee the development of the firm-wide operational risk framework, as well as major changes to the framework. Management roles and accountability must be clearly established.

S 3. The board of directors and management must ensure that appropriate resources are allocated to support the operational risk framework.

S 4. The institution must have an independent operational risk management function that is responsible for overseeing the operational risk framework at the firm level to ensure the development and consistent application of operational risk policies, processes, and procedures throughout the institution.

S 5. The firm-wide operational risk management function must ensure appropriate reporting of operational risk exposures and loss data to the board of directors and senior management.

S 6. Line of business management is responsible for the day-to-day management of operational risk within each business unit.

S 7. Line of business management must ensure that internal controls and practices within their line of business are consistent with firm-wide policies and procedures to support the management and measurement of the institution's operational risk.

S 8. The institution must have policies and procedures that clearly describe the major elements of the operational risk management framework, including identifying, measuring, monitoring, and controlling operational risk.

S 9. Operational risk management reports must address both firm-wide and line of business results. These reports must summarize operational risk exposure, loss experience, relevant business environment and internal control assessments, and must be produced no less often than quarterly.

S 10. Operational risk reports must also be provided periodically to senior management and the board of directors, summarizing relevant firm-wide operational risk information.

S 11. An institution's internal control structure must meet or exceed minimum regulatory standards established by the Agencies.

S 12. The institution must demonstrate that it has appropriate internal loss event data, relevant external loss event data, assessments of business environment and internal controls factors, and results from scenario analysis to support its operational risk management and measurement framework.

S 13. The institution must include the regulatory definition of operational risk as the baseline for capturing the elements of the

[16] In this document, the terms ''database'' and ''data warehouse'' are used interchangeably to refer to a collection of data arranged for easy retrieval using computer technology.

AMA framework and determining its operational risk exposure.

S 14. The institution must have clear standards for the collection and modification of the elements of the operational risk AMA framework.

S 15. The institution must have at least five years of internal operational risk loss data[17] captured across all material business lines, events, product types, and geographic locations.

S 16. The institution must be able to map internal operational risk losses to the seven loss-event type categories.

S 17. The institution must have a policy that identifies when an operational risk loss becomes a loss event and must be added to the loss event database. The policy must provide for consistent treatment across the institution.

S 18. The institution must establish appropriate operational risk data thresholds.

S 19. Losses that have any characteristics of credit risk, including fraud-related credit losses, must be treated as credit risk for regulatory capital purposes. The institution must have a clear policy that allows for the consistent treatment of loss event classifications (*e.g.,* credit, market, or operational risk) across the organization.

S 20. The institution must have policies and procedures that provide for the use of external loss data in the operational risk framework.

S 21. Management must systematically review external data to ensure an understanding of industry experience.

S 22. The institution must have a system to identify and assess business environment and internal control factors.

S 23. Management must periodically compare the results of their business environment and internal control factor assessments against actual operational risk loss experience.

S 24. Management must have policies and procedures that identify how scenario analysis will be incorporated into the operational risk framework.

S 25. The institution must have a comprehensive operational risk analytical framework that provides an estimate of the institution's operational risk exposure, which is the aggregate operational loss that it faces over a one-year period at a soundness standard consistent with a 99.9 per cent confidence level.

S 26. Management must document the rationale for all assumptions underpinning its chosen analytical framework, including the choice of inputs, distributional assumptions, and the weighting across qualitative and quantitative elements. Management must also document and justify any subsequent changes to these assumptions.

S 27. The institution's operational risk analytical framework must use a combination of internal operational loss event data, relevant external operational loss event data, business environment and internal control factor assessments, and scenario analysis. The institution must combine these elements in a manner that most effectively enables it to quantify its operational risk exposure. The institution can choose the analytical framework that is most appropriate to its business model.

S 28. The institution's capital requirement for operational risk will be the sum of expected and unexpected losses unless the institution can demonstrate, consistent with supervisory standards, the expected loss offset.

S 29. Management must document how its chosen analytical framework accounts for dependence (e.g., correlations) among operational losses across and within business lines. The institution must demonstrate that its explicit and embedded dependence assumptions are appropriate, and where dependence assumptions are uncertain, the institution must use conservative estimates.

S 30. Institutions may reduce their operational risk exposure results by no more than 20% to reflect the impact of risk mitigants. Institutions must demonstrate that mitigation products are sufficiently capital-like to warrant inclusion in the adjustment to the operational risk exposure.

S 31. Institutions using the AMA approach for regulatory capital purposes must use advanced data management practices to produce credible and reliable operational risk estimates.

S 32. The institution must test and verify the accuracy and appropriateness of the operational risk framework and results.

S 33. Testing and verification must be done independently of the firm-wide operational risk management function and the institution's lines of business.

Dated: July 17, 2003.

John D. Hawke, Jr.,

Comptroller of the Currency.

By order of the Board of Governors of the Federal Reserve System, July 21, 2003.

Jennifer J. Johnson,

Secretary of the Board.

Dated at Washington, DC, this 11th day of July, 2003.

By order of the Board of Directors.

Federal Deposit Insurance Corporation.

Robert E. Feldman,

Executive Secretary.

Dated: July 18, 2003.

By the Office of Thrift Supervision.

James E. Gilleran,

Director.

[FR Doc. 03–18976 Filed 8–1–03; 8:45 am]

BILLING CODE 4810–33–P; 6210–01–P; 6714–01–P; 6720–01–P

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[17] With supervisory approval, a shorter initial historical observation period is acceptable for banks newly authorized to use an AMA methodology.

Federal Register

Monday,
August 4, 2003

Part III

Department of Agriculture

Agricultural Marketing Service

7 CFR Part 983

Pistachios Grown in California; Recommended Decision and Opportunity To File Written Exceptions to Proposed Marketing Agreement and Order No. 983; Proposed Rule

DEPARTMENT OF AGRICULTURE

Agricultural Marketing Service

7 CFR Part 983

[Docket No. AO–F&V–983–2; FV02–983–01]

Pistachios Grown in California; Recommended Decision and Opportunity To File Written Exceptions to Proposed Marketing Agreement and Order No. 983

AGENCY: Agricultural Marketing Service, USDA.

ACTION: Proposed rule and opportunity to file exceptions.

SUMMARY: This recommended decision proposes the issuance of a marketing agreement and order (order) for pistachios grown in California. The proposed order would set standards for the quality of pistachios produced and handled in California by establishing a maximum aflatoxin tolerance level, maximum limits for defects, a minimum size requirement, and mandatory inspection and certification. An eleven-member committee, consisting of eight producers, two handlers, and one public member, would locally administer the program. The program would be financed by assessments on handlers of pistachios grown in the production area. The objective of the program would be to enhance grower returns through the delivery of higher-quality pistachios to consumers. This rule also announces the Agricultural Marketing Service's intention to request approval by the Office of Management and Budget of new information collection requirements to implement this program.

DATES: Written exceptions must be filed by September 3, 2003. Pursuant to the Paperwork Reduction Act, comments on the information collection burden must be received by October 3, 2003.

ADDRESS: Four copies of all written exceptions should be filed with the Hearing Clerk, U.S. Department of Agriculture, room 1081–S, Washington, DC 20250–9200, Facsimile number (202) 720–9776. All comments should reference the docket number and the date and page number of this issue of the **Federal Register**. Comments will be made available for public inspection in the Office of the Hearing Clerk during regular business hours, or can be viewed at: *http://www.ams.usda.gov/fv/moab.html.*

FOR FURTHER INFORMATION CONTACT: Melissa Schmaedick, Marketing Order Administration Branch, Fruit and Vegetable Programs, Agricultural Marketing Service, USDA, Post Office Box 1035, Moab, UT 84532, telephone: (435) 259–7988, fax: (435) 259–4945; or Anne M. Dec, Marketing Order Administration Branch, Fruit and Vegetable Programs, AMS, USDA, 1400 Independence Avenue SW., Stop 0237, Washington, DC 20250–0237; telephone: (202) 720–2491, fax: (202) 720–8938. Small businesses may request information on this proceeding by contacting Jay Guerber, Marketing Order Administration Branch, Fruit and Vegetable Programs, AMS, USDA, 1400 Independence Avenue SW., Stop 0237, Washington, DC 20250–0237; telephone: (202) 720–2491, fax: (202) 720–8938.

SUPPLEMENTARY INFORMATION: Prior documents in this proceeding: Notice of Hearing issued on June 19, 2002, and published in the June 26, 2002, issue of the **Federal Register** (67 FR 43045).

This action is governed by the provisions of sections 556 and 557 of title 5 of the United States Code and is therefore excluded from the requirements of Executive Order 12866.

Preliminary Statement

Notice is hereby given of the filing with the Hearing Clerk of this recommended decision with respect to the proposed marketing agreement and order regulating the handling of pistachios grown in California, and the opportunity to file written exceptions thereto. Copies of this decision can be obtained from Melissa Schmaedick, whose address is listed above.

This recommended decision is issued pursuant to the provisions of the Agricultural Marketing Agreement Act of 1937, as amended (7 U.S.C. 601 *et seq.*), hereinafter referred to as the ''Act,'' and the applicable rules of practice and procedure governing the formulation of marketing agreements and orders (7 CFR part 900).

The proposed marketing agreement and order are based on the record of a public hearing held July 23–25, 2002, in Fresno, California. The hearing was held to receive evidence on the proposed marketing order from producers, handlers, and other interested parties located throughout the proposed production area. Notice of this hearing was published in the **Federal Register** on June 26, 2002.

This proposal is the result of nearly three years of efforts undertaken by the Proponents Committee (proponents), a group representing the majority of producers and handlers of pistachios in California. The Proponents Committee was established in 2000 as a result of renewed industry interest in a Federal marketing order.

An earlier attempt to establish a Federal marketing order in 1996 on behalf of the pistachio industry by the California Pistachio Commission (CPC or Commission) and the Western Pistachio Association (Association) was terminated in 2000 due to a lack of industry support for certain proposed provisions. The current proposal is different from that which was previously proposed since many controversial issues have either been removed or resolved through more exacting specifications in the proposed order. The Proponents Committee is independent of the Commission and the Association.

Witnesses at the hearing explained that the provisions of this proposal aim to provide the California pistachio industry with a tool to regulate the quality of pistachios handled in California. This would include preventing pistachios containing aflatoxin above the proposed permitted maximum tolerance level of 15 parts per billion (ppb) from entering the market place. The proposed order would also preclude defective and small pistachios from being sold. Under the proposed order, testing and certification of pistachios for quality (including aflatoxin) would be mandatory. A mandatory regulatory program would provide the industry with an effective means of ensuring product quality, thereby enhancing customer satisfaction.

At the conclusion of the hearing, the Administrative Law Judge fixed September 23, 2002, as the final date for interested persons to file proposed findings and conclusions or written arguments and briefs based on the evidence received at the hearing. One brief was filed on behalf of the Proponents Committee in support of the proposed program and its provisions. The brief also recommended certain changes in the regulatory text of the proposed order as a result of the public hearing held in Fresno, California from July 25 through July 27, 2002. These changes are discussed as appropriate later in this document.

Material Issues

The material issues presented on the record of hearing are as follows:

1. Whether the handling of pistachios produced in the production area is in the current of interstate or foreign commerce or directly burdens, obstructs, or affects such commerce;

2. Whether the economic and marketing conditions are such that they justify a need for a Federal marketing agreement and order which would tend

to effectuate the declared policy of the Act;

3. What the definition of the production area and the commodity to be covered by the order should be;

4. What the identity of the persons and the marketing transactions to be regulated should be;

5. What the specific terms and provisions of the order should be, including:

(a) The definitions of terms used therein which are necessary and incidental to attain the declared objectives and policy of the Act and order;

(b) The establishment, composition, maintenance, procedures, powers and duties of an administrative committee for pistachios that would be the local administrative agency for assisting USDA in the administration of the order;

(c) The authority to incur expenses and the procedure to levy assessments on handlers to obtain revenue for paying such expenses;

(d) The establishment of mandatory inspection and certification for aflatoxin, quality and size requirements for California pistachios;

(e) The establishment of requirements for handler reporting and recordkeeping;

(f) The requirement for compliance with all provisions of the order and with any regulations issued under it;

(g) The requirement for periodic continuance referenda;

(h) An exemption for handlers of non-commercial quantities of pistachios;

(i) Coordination of administration with the California Pistachio Commission program;

(j) Additional terms and conditions as set forth in § 983.59 through § 983.69 of the Notice of Hearing published in the **Federal Register** of June 26, 2002, which are common to all marketing agreements and orders, and other terms and conditions published at § 983.90 through § 983.92 that are common to marketing agreements only; and

6. Whether the proposed marketing order and its provisions, if approved in grower referendum, should be implemented in two phases.

Findings and Conclusions

The following findings and conclusions on the material issues are based on the record of the hearing.

Material Issue Number 1—Whether the Handling of California Pistachios is in the Current of Interstate or Foreign Commerce

The record indicates that the handling of pistachios grown in California is in the current of interstate or foreign commerce or directly burdens, obstructs or affects such commerce.

Witnesses testifying at the hearing stated that over 97 percent of the pistachios produced in the United States are grown in California orchards. There are minor amounts of commercial plantings in eastern Arizona and New Mexico. However, it is estimated that these States account for only 2 and less than 1 percent of national production, respectively.

The record shows that domestic consumption of California pistachios is well established, with the U.S. market representing an estimated 70 percent of total production distributed in 1999–2000. Pistachios grown in the proposed production area are shipped throughout the United States, and the California industry, through the Commission, conducts a national promotion program for its product.

The record also shows that export markets are increasingly important to California producers and handlers. About 30 percent of the crop is sold in foreign markets in more than 40 countries. According to the 2000–2001 CPC Annual Report, Germany, Japan, Canada and Hong Kong are California's largest pistachio export destinations. Exports to Germany alone accounted for 20 percent of total inshell pistachio exports in 1999–2000.

Evidence presented at the hearing confirmed that any handling of California pistachios in market channels, including intrastate shipments, exerts an influence on all other handling of such pistachios. Thus, it is concluded that the handling of pistachios grown in the proposed production area is in the current of interstate and foreign commerce and directly affects such commerce.

Material Issue Number 2—The Need for a Pistachio Marketing Order

The record evidence demonstrates that there is a need for a marketing order for California pistachios.

Farming pistachios is a costly investment with a significant delay in benefits and an unreliable crop yield. Increasing yields have led to an increasing overall value of California pistachio production. However, to remain economically viable, producers must maintain a level of return per pound harvested that covers their cost of production. Witnesses of the proposed order assert that maintaining a high level of quality product in the market will lead to increasing consumer demand and stability in producer returns.

Poor quality pistachios impact demand, and the potential growth of demand, for pistachios. Characteristics routinely deemed as ''poor quality'' by customers of the California pistachio industry include small size, and excessive internal and external blemishes. Market studies and references to customer comment databases presented by witnesses at the hearing demonstrate that the presence of poor quality pistachios in the marketplace significantly impacts demand in a negative way.

According to record evidence, minimizing the level of aflatoxin in California pistachios is another significant quality factor, since aflatoxin is a known carcinogenic. Consumer concerns over aflatoxin can impact their perception of the quality of pistachios, and therefore negatively impact demand. Moreover, any market disturbances related to aflatoxin in pistachios, regardless of the origin of those pistachios, could have a detrimental effect on the California pistachio industry. A regulatory program limiting the amount of aflatoxin tolerated in pistachios would be useful to bolster consumer confidence in the quality of California pistachios.

Pistachio acreage has consistently increased in California, from just over 20,000 bearing acres in 1979 to 78,000 bearing acres in 2001. The number of non-bearing acres (*i.e.*, acres less than 7 years old, not yet in full production) has also shown consistent growth, increasing from 17,062 acres in 1997 to 23,500 acres in 2001. Yield per acre has also been steadily rising. Over the 1976–1980 period, average yield per bearing acre measured 1,097 pounds; by 1996–2000, this average increased to 2,418 pounds.

Higher yields and increasing acreage have resulted in increasing production. According to information submitted by the California Pistachio Commission, production in 2000 totaled 242 million pounds, a 64 percent increase over 1995 production, which totaled 148 million pounds. Moreover, witnesses at the hearing indicated that maturing acreage, absent any additional new plantings, will likely result in a 60 percent increase in California pistachio production over the coming years.

Several witnesses at the hearing testified that, in light of increasing production, future stability of market returns is reliant on continually increasing consumer demand for pistachios. These witnesses stated that strong consumer demand, which is ultimately related to consumer perceptions of product quality, is essential to the continued economic well-being of the California pistachio industry. Moreover, witnesses discussed the importance of implementing a marketing order program that would provide a regulatory structure to monitor and ensure that minimum quality standards are not compromised as production of California pistachios increases. One of the most important quality characteristics cited by witnesses is the regulation of aflatoxins as these carcinogenic molds can be found in improperly handled pistachios.

The proposed order would set quality standards for pistachios produced and handled in California by establishing a maximum aflatoxin tolerance level, maximum limits for defects, a minimum size requirement, and mandatory inspection and certification. Witnesses of the proposed marketing order argued that this regulatory program would bolster consumer demand for pistachios.

The relationship among product quality, consumer demand, and producer returns in the pistachio industry was demonstrated at the hearing. Pistachio production is not only costly in terms of initial investment and cultural costs, but it is highly unpredictable in terms of returns. Between the initial processes of cleaning, hulling, sorting and drying, a significant portion of the initial volume harvested is reduced. This volume is further reduced as the handling process reaches its final stages of further sorting for quality and final preparation for market. As such, witnesses explained that ultimate pistachio sales are based on approximately 30 percent of the volume initially harvested from the field. Because of this, witnesses stated that the process of extracting the highest quality portion of the harvest, and ensuring consumer satisfaction with that product, is crucial to determining the value of the crop.

Pistachio production is similar to other nut crops in that yield and total production are impacted by the alternate bearing nature of pistachio trees (meaning cyclical high and low production years). In addition, producer returns and total crop value are dependent on the overall quality of the crop. One example is the percentage of harvest that is either ''open shell'' or ''closed shell.'' Each harvest yields a certain percentage of nuts that have not naturally opened prior to harvest. These nuts are classified as ''closed shell,'' ''shelling stock'' or ''non-splits,'' and have a lower market value than those nuts that are naturally split, or ''open shell.'' As the percentage of open-shells varies, the total value of production can change significantly from one year to the next.

Total value and value per acre are generally higher in high yielding years. An economic analysis of the California pistachio industry presented at the hearing by Dr. Dan Sumner of the University of California, Davis, indicates that trends for total crop value and value per bearing acre have been increasing over the past 20 years. In 1980, the total value of the pistachio crop in California was $55.8 million. By 2000, total crop value had increased more than four-fold, reaching $236.72 million. These gains are attributed to increases in both total pistachio producing acreage and yield per acre. Average value per bearing acre increased from $1,642 per acre in 1980–1984 to $2,658 per acre in 1996–2000.

Conversely, grower return per pound is generally higher in low yielding years. According to CPC historical price data, price per pound has gradually decreased over the past 20 years, ranging from a high of $2.05 per pound in 1980 to a low of $0.98 per pound in 2000. Thus, in terms of current producer ability to reconcile production costs with receipts, yield per acre must be sufficiently high to compensate for low returns in price per pound. According to the record, the proposed order would assist in stabilizing, if not increasing, producer returns for pistachios. The quality requirements proposed herein would not only assist in fortifying consumer demand by ensuring consumer satisfaction with product quality, but mandatory quality standards would also boost domestic prices by culling poor product, which tends to have price-depressing effects, from the market.

The record evidence is that total costs of production can be divided into three categories: the costs of orchard establishment, cultural costs and administrative costs. Establishment costs, or the overall cost to develop an acre of pistachios until revenues exceed growing expenses, are estimated at between $10,000 and $15,000, with an average tree maturation period of 7 years. In order to recover these investment costs, the hearing record indicates that producers generally target an 11 per cent return on investment, estimated at between $1,100 and $1,650 per acre. Annual per acre cultural costs average between $1,100 and $1,600, once the trees are productive. Administrative costs include the cost of farm management and crop financing, and range from $150 to $200 per acre.

Given the cost estimates above, a producer would need to harvest an average of 2,000 pounds per acre to cover total production costs. This calculation assumes an average field price of $1.25 per pound, which is based on 24 years of CPC crop value statistics. For example, minimum estimated cultural costs plus administrative costs and an 11 percent return on investment results in a minimum total production cost of $2,350 per acre per year. Total production costs less the targeted 11 percent return on investment equals $1,250 per acre, or an average harvest of 1,000 pounds per acre to cover production costs without a return on investment.

While the CPC 2002 Annual Report indicates a State average of $2,619 per acre in gross receipts over the last four years, 1998–2001 CPC yield per acre information reveals that only 6 out of 26 California counties with pistachio production yield on average more than 2,000 pounds per acre. These counties include Colusa, Sutter, Madera, Fresno, Kings and Kern, and together represent over 88 percent of total California pistachio production between the years 1998 to 2001. Glenn, Butte, Placer, Yolo, Contra Costa, San Joaquin, Calaveras, Stanislaus, Merced, Tulare and Santa Barbara counties yield on average between 1,000 to 2,000 pounds per acre and represent roughly 12 percent of total State production. Shasta, Tehama, Yuba, Solano, Sacramento, San Luis Obispo, Los Angeles, San Bernardino and Riverside counties yield on average less than 1,000 pounds per acre and represent less than one percent of California pistachio production.

Given the assumptions made above, approximately 88 percent of the industry is covering total costs of production. Conversely, roughly 12 percent of the industry is currently covering cultural costs but not generating a return on their investment.

In 1996, high levels of aflatoxin were detected in foreign pistachios imported into the European Union (EU). Publicity about the presence of aflatoxin at high levels first led to a total ban on imports and has since reduced the number of pistachios imported from all sources into the EU by 45 percent. In Germany the drop was 60 percent, and by 2000 imports were still only 53 percent of 1997 levels.

Witnesses testifying at the hearing used this case of pistachios contaminated with aflatoxin, and the subsequent damage to consumer confidence and demand for pistachios in the EU, to demonstrate the industry's need to safeguard against similar findings in California pistachios. According to those who testified, mandatory inspection and certification against high levels of aflatoxin would be the most effective means of preventing such an event with pistachios handled in California.

Similarly, witnesses stressed the need to have a mandatory regulatory system in place in the event that aflatoxin were found in non-California pistachios, but were to universally impact the demand of all pistachios, regardless of origin. If such an event were to occur, witnesses of the order stressed the usefulness of having a federally regulated program for aflatoxin in order to maintain consumer confidence with regard to California pistachios.

Evidence presented at the hearing supports a Federal marketing order for pistachios grown in California. In view of the foregoing, and based on the record of the proceeding, it is concluded that current economic and marketing conditions justify a need for a marketing order for California pistachios. The order would meet many needs of the industry and would tend to effectuate the declared policy of the Act.

Material Issue Number 3—Definition of Pistachio and Production Area

Definitions of the terms ''pistachio'' and ''production area'' should be included in the order to delineate the commodity and the area that would be regulated under the provisions of the proposed program.

''Pistachio'' should be defined to mean the nut or nuts of the pistachio tree, genus Pistacia Vera. The term ''pistachio'' would cover all fruits of the Pistcaia Vera grown in the production area, whether inshell or shelled. Pistachios grown outside the production area would not be covered by the proposed order.

Record evidence explains that the pistachio nut is the seed of a semidry drupaceous fruit, or stone fruit, much like peaches and mangos. However, while peach flesh is eaten and the seed discarded, the opposite is true of the pistachio; the flesh or ''hull'' is discarded and the seed, once it has been freed from protection of the thin, bony shell, is eaten.

Pistachio development starts with a seedling being grown in a pot in a nursery for nearly two years. The seedlings are then transplanted into the field at a rate of 130 to 160 seedlings per acre, usually in January or February when the seedlings are dormant. Toward the end of the first growing season these seedlings are then grafted or budded in the field to Pistacia Vera, both male and female. The pistachio tree is dioecious, meaning there are both ''male'' and ''female'' trees, and is pollinated by the wind. The typical California pistachio orchard requires one male tree for every 8–24 females.

Pistachio trees typically require six years of maturation after budding to produce a commercial crop. During the maturation period, young trees require considerable care, including yearly pruning, irrigation, fertilizer application and pest control, thus contributing to the considerable investment costs of establishing a pistachio orchard. Harvest of a tree's first commercial-sized crop typically occurs in the tree's seventh year. The crop and tree continue to grow in size for another seven to eight years until the tree is considered fully mature and has reached a height of approximately 25 to 30 feet.

Pistachio trees require a significant dormant period, currently estimated to be 800 hours below 45°F, followed by long, hot, dry summers. The trees are pruned during dormancy, and once they bloom, in late March or early April, they need to be irrigated, fertilized and treated for various pests during the rest of the year. The major input is usually water, as each acre requires approximately 36'' of water to be applied during the growing season if the trees are to produce a full crop.

Currently there is no consensus as to the useful commercial life of a tree. Pistachio trees in the Middle East have lived for thousands of years. Trees appear to be long lived in California, although producers must replace 2 to 3 percent of their trees that die from disease or other causes every year. The overall cost to develop an acre of pistachios until revenues exceed growing expenses is between $10,000 and $15,000 per acre, and does not differ significantly due to the size of the planting.

The term ''production area'' should be defined to mean the State of California. The record shows that the production area defined in the proposed order is the major pistachio producing area in the United States.

Witnesses testifying at the hearing stated that over 97 percent of the pistachios produced in the United States are grown in California orchards. Production is concentrated in six counties in the San Joaquin Valley, in the central part of the State. However, commercial production is reported in an additional 20 counties throughout California. While there are some counties in the State in which no pistachios are currently produced, witnesses testified that the production area should be defined to allow for coverage of any new pistachio development outside current plantings within California.

Witnesses also proposed coverage of the entire State because the industry (through the California Pistachio Commission) finances national and international promotion programs to expand demand for California pistachios. Thus, buyers of California pistachios consider the entire State to be the pistachio producing area.

While the proposed Federal order and the State commission would operate independently of each other, witnesses testified that the quality assurance standards implemented under the proposed order would complement the promotion activities undertaken by the Commission. Thus, they believed that having the two programs would benefit the California pistachio industry.

Record evidence indicates that there are minor amounts of commercial plantings in eastern Arizona and New Mexico. However, it is estimated that these states produce only 2 and less than one percent of national production, respectively.

Witnesses explained that Arizona and New Mexico had been considered as part of the production area during the initial stages of drafting the proposed order. According to record testimony, although there is some interest in the proposed marketing order among Arizona and New Mexico pistachio producers, support in those States is not strong enough to warrant including them in the proposed production area.

Record evidence also indicates that pistachios produced in Arizona and New Mexico are mainly consumed within the respective State boundaries and have a relatively limited presence in national and international markets. Moreover, acreage in both States is neither increasing, nor is it expected to increase in the future, as climate factors limit the growth potential of existing pistachio orchards. Pistachio production from these States is not considered to represent a significant portion of total domestic production. It is also unlikely that Arizona and New Mexico pistachios will hold a significant presence in domestic and international markets in the future.

Lastly, information presented at the hearing indicates that California nurserymen have sold a limited amount of pistachio trees into other western states, such as Nevada, Utah and Texas, but there is no known significant commercial production in these States. Production from these States is not believed to enter into the current of interstate commerce.

The Act requires that marketing orders be limited in their application to the smallest regional production area found practicable. For the reasons given above, it is concluded that covering pistachios grown in California (and not those grown in other States) under the proposed order is consistent with carrying out the declared policy of the Act and, therefore, the production area should be defined as hereinafter set forth.

Material Issue Number 4—Definition of Handler and Handle

The term ''handler'' should be defined to identify the persons who would be subject to regulation under the order. Such term should apply to any person who handles pistachios within the production area, or places pistachios in the current of commerce within the production area, or in the current of commerce between the production area and any point outside thereof. A handler could be an individual, a joint venture, partnership, corporation, or other business entity.

The definition of ''handler'' identifies persons who would be responsible for meeting the requirements of the order, including paying assessments, complying with testing and certification provisions of the order, and submitting reports and other information required for the administration of the proposed program. The term is also used to identify those persons who are eligible to vote for, and serve as, handler members and alternate members on the committee.

The term ''handle'' should be defined in the order to establish the specific functions that would place pistachios in the current of commerce within the production area, or between the production area and any point outside thereof, and to provide a basis for determining which functions are subject to regulation under the authority of the proposed marketing order.

''Handle'' should be defined to mean engaging in: (a) Receiving pistachios, (b) hulling and drying pistachios, (c) further preparing pistachios by sorting, sizing, shelling, roasting, cleaning, salting, and/or packaging for marketing in or transporting to any and all markets in interstate or foreign commerce, and (d) placing pistachios into the current of commerce between the production area and any point outside that area.

The record evidence is that the handling of pistachios is a multi-step process. Witnesses described the harvest and initial processing (hulling and drying) of pistachios as an intense period of activity, typically beginning in early September, when the pistachio nuts are mature, and lasting for a period of 20 to 30 days.

The trees are deemed ready for harvest when the ''hull'' slips on the shell when pressure is applied. By this time, approximately 75 percent of the nuts have naturally ''split,'' meaning that the shell has naturally opened to give its characteristic ''open mouth'' appearance. This splitting of the shell typically will not be apparent, as the hull or outer layer remains intact, protecting the kernel from fungal infection and insect infestation. The hulls of some pistachios, however, may split, thereby revealing the tender pistachio nut inside. These pistachios, referred to as ''early splits,'' are more prone to mold or insect infestation.

The balance of the pistachio harvest has not naturally opened. These are referred to as ''closed shell'' or ''non-split'' pistachios.

According to record testimony, pistachios must be rapidly harvested when mature in order to prevent insect infestation and staining of the shell, and to avoid difficulty of handling an overripe product. During the harvest process, each tree is mechanically shaken to cause the pistachio nuts to fall into a catching frame. This method of harvesting allows the California pistachio industry to harvest pistachios without the nuts having to touch the ground, thereby avoiding possible contamination from soil-borne molds or insects. The nuts are then dumped from the catching frames into bins or trucks and readied for transport to the handler.

The nuts, which contain a significant amount of moisture when harvested, must arrive at the handling facility as soon as possible after harvest. If the nuts are not hulled within 24 hours of their removal from the tree, staining of the outer shell occurs, and this is considered detrimental in the marketplace. Due to the short harvest period and the significant investment in equipment at the handling facility, witnesses explained that pistachio harvest will typically take place 24 hours a day 7 days a week until harvest is complete.

At the handling facility, the nuts are weighed and emptied from the trailers. As the emptying of bins or trucks takes place, usually through bottom dump trailers into a pit, the nuts are sampled. This sampling of wet product is used to determine the quality and payable weight of the nuts being delivered.

Once the nuts have been sampled and the trash (*i.e.*, leaves, twigs, *etc.*) has been removed, the hull or the outer layer covering the shell is removed by equipment that resembles large potato peelers. Once hulled, the pistachios are then moved through various dewatering devices prior to entering a dryer. Some handlers do some initial quality sorting between hulling and drying, but this is not universal. The nuts are then dried in high-powered dryers to about 14 percent moisture. After drying, they are placed in storage in containers that vary from 500-pound bins to 1,000,000-pound silos. During the initial phase of storage, the nuts continue to be dried by air circulation, to get them down to a safe, long-term storage moisture content of around 6 percent. At this stage, the nuts are stable and can remain in storage for up to two years.

The sample taken at delivery is processed like the rest of the nuts, *i.e.*, the trash is removed and the nuts in the sample are hulled and then dried before sorting. An assessment of the quality of the sample is then made. The assessment may include such things as a determination of the percentage of naturally split nuts, the color of the shells, and the amount of insect infestation (if any). This delivery sample may be used to determine payment to the producer, and to give the handler some idea of the characteristics of the crop he or she has to process.

The record shows that producers often commit their nuts to more than one handler. The normal practice in the industry is to have contracts between producers and handlers, many of them multi-year and often with premiums for quality. Many of the contracts also have minimum prices. Apart from this minimum price, the producer often does not know what final price he/she will receive for the pistachios. The handler makes interim payments throughout the year culminating in a final payment, usually in August following the previous September's harvest. The amount paid by the handler will depend in large part on the price that he or she obtained for the processed crop, and the costs of handling the pistachios.

When the nuts are removed from storage, the nuts are sorted, sized, graded and mechanically separated into open and closed shell product. These activities can take place in different sequences and the process varies among handling facilities. As part of this process, a considerable amount of trash, bad nuts, loose shells, etc., are removed from the product stream. At this stage, the nuts may be ready for market. However, some California pistachios are then roasted and salted by the handler prior to being placed in consumer or industrial size packages to be marketed.

Once the nuts have been roasted and salted, their shelf life is reduced as they can become rancid or stale, and they need to be stored at temperatures approximating 35 degrees Fahrenheit in order to remain completely stable. If they are not placed in cold storage, they have a shelf life of approximately nine months.

The record shows that all of these activities, from initial receipt of the pistachios at the handling facility, to final packaging of the product, should be included in the definition of ''handle.'' These activities were identified as those necessary to prepare pistachios for entering the stream of commerce and, as such, should be included in the definition of the process which makes a person a ''handler,'' and, thus, subject to regulation under the proposed order.

In addition, the hearing record indicates that placing California pistachios into the current of commerce from within the production area to points outside thereof for the purpose of hulling and drying, or further processing would also constitute handling. In such cases, the individual responsible for placing California pistachios into the current of commerce would be considered a handler and would be subject to the provisions of the proposed order.

USDA recommends adding a paragraph (d) to § 983.14 of the proposed order as it appeared in the Notice of Hearing. To clarify the definition of ''handle,'' the following language is proposed to be added: ''Placing California pistachios into the current of commerce from within the production area to points outside thereof.''

According to the record, the acts of transporting pistachios from a producer's orchard to a processing plant within the production area and of transporting pistachios between handlers within the production area should be excluded from the definition of ''handle.''

The transportation of pistachios from the orchard to the handling facility is typically either performed by the producer him or her self, or contracted out to third parties. Given that neither the producer nor the contract hauler would be engaged in the process of preparing pistachios for market in this capacity, their activities should be excluded from those considered as part of ''handling.''

Similarly, witnesses stated that pistachios are customarily traded among handlers, and that this activity should not be considered part of the definition of ''handling.'' Trade among handlers predominantly occurs as a means for individual handlers to buy or sell surplus pistachios and to meet the demands of their respective customers. Witnesses also explained that some handlers are better equipped to handle pistachios that present processing problems. For example, pistachios requiring re-working to meet industry quality standards may be transferred from one handler to another for more efficient processing.

The record evidence is that most producers do not handle their own pistachios. However, a producer would become a handler if the producer performs any handling functions. For example, a producer that hulls and dries pistachios before shipment for further preparation for marketing would be considered a handler. Once a producer becomes a handler, he or she would be subject to the proposed order provisions.

Material Issue Number 5(a)—Other Definitions

(a) Certain terms should be defined for the purpose of specifically designating their applicability and limitations whenever they are used in the order.

''Accredited laboratory'' should be defined to mean a USDA laboratory or any other laboratory that has been approved or accredited by the U.S. Department of Agriculture for testing aflatoxin in pistachios. Witnesses testified that the aflatoxin testing and certification provisions of the proposed order are key components of the quality control program deemed necessary by the California pistachio industry. In order for the testing and certification process to be credible, the order should provide that the laboratories performing these functions must be accredited or approved by USDA.

''Act'' should be defined as the Agricultural Marketing Agreement Act of 1937, as amended (7 U.S.C. 601–674). This is the statute under which the proposed regulatory program would be operative, and this definition avoids the need to refer to the citation throughout the order.

According to record evidence, ''affiliation'' should be defined, as it is important within the context of proposed eligibility requirements for committee members and their alternates. Witnesses testified that ''affiliation'' should be defined to mean a person who is: (1) A producer or handler that directly or indirectly, through one or more intermediaries, owns or controls, or is controlled by or is under common control with the producer or handler specified; or, (2) a producer or handler who directly or indirectly through one or more intermediaries, is connected in a proprietary capacity or shares the ownership or control of the specified producer or handler with one or more other producers or handlers.

According to the hearing record, the term ''control'' should be further defined to mean ''the possession, direct or indirect, of the power to direct or cause the direction of the management of policies of a handler or a producer whether through voting securities, membership in a cooperative, by contract or otherwise.''

Witnesses explained that this definition of ''affiliation'' is proposed to ensure that persons who are in business together as handlers or producers are limited in their representation on the administrative committee. Further discussion of affiliation and its intended use under the provisions of the proposed order appears under material issue 5(b), the establishment of an agency to locally administer the order.

''Aflatoxin'' should be defined as one of the several carcinogenic mycotoxins produced by naturally occurring molds. Aflatoxin can be found, and can spread, in improperly processed and stored nuts, dried fruits and grains. According to information presented at the hearing, this group of fungal toxins is produced by the molds Aspergillus flavus and Aspergillus parasiticus. Aflatoxin is a known carcinogen and potential contaminant for pistachios.

Proposed § 983.38 sets forth a maximum aflatoxin level of 15 parts per billion (ppb) for California pistachios. This threshold was substantiated by testimony from experts in the field of aflatoxin and food contaminants, and is further discussed under material issue 5(d).

''Aflatoxin inspection certificate'' should be defined to mean a certificate issued by a laboratory that is accredited or approved by USDA to indicate that a lot of pistachios was tested for and met the aflatoxin quality requirements proposed in this order. In particular, an ''aflatoxin inspection certificate'' would indicate that the pistachios have been tested for aflatoxin and the aflatoxin in the nuts, if any, did not exceed a level of 15 ppb. Under the provisions of this proposed order, no handler could ship pistachios for domestic human consumption that exceed an aflatoxin level of 15 ppb. Witnesses explained that any handler placing California pistachios into the stream of domestic commerce for the purpose of human consumption would be required to obtain an aflatoxin inspection certificate for each lot of pistachios handled. Aflatoxin certificates would also be important for committee record-keeping and auditing responsibilities with regard to local administration of the order.

''Assessed weight'' should be defined to mean the weight of all pistachios, clear of debris, hulled and measured at 5 percent moisture, that are received for processing by a handler within each production year. Calculation of the assessed weight would be based on the weight of the pistachios received from the field. As the handler receives pistachios, a delivery sample would be taken, and the nuts in that sample cleaned, hulled and dried to 5 percent moisture content. The actual weight of the pistachios received would then be adjusted to reflect the characteristics of the delivery sample and its final weight when dried to 5 percent moisture content. According to the record, the 5 percent moisture content is an industry standard used by all handlers.

In calculating the ''assessed weight'' for loose kernels, witnesses explained that the calculation method proposed in the order reflects current industry practices. To determine the weight of the kernels without shells, the weight of the kernel would be multiplied by two as it is generally accepted that the shell accounts for approximately half of the weight of a whole pistachio nut.

Witnesses also explained that assessments placed on pistachio handlers would be based on the volume of pistachios received by each handler for processing during a production year. Hence, the term ''assessed weight'' is essential to the committee's assessment collection. This term is further discussed in connection with proposed § 983.53, ''Assessments.''

The definition contained in the Notice of Hearing defined assessed weight as ''* * * edible inshell pistachios received for processing by a handler * * * .'' USDA recommends deleting the word ''edible'' from the definition. This would correct a conflict between the Notice of Hearing definition of ''assessed weight'' and the proposed definition of ''edible pistachios,'' § 983.13. The definition proposed under § 983.13, discussed later in this document, states that edible pistachios are pistachios that do not exceed aflatoxin and other quality provisions of the order described under §§ 983.38 and 983.39. Pistachios received from the field for processing by the handler have yet to be tested and certified as having met the proposed provisions of §§ 983.38 and 983.39. Therefore, USDA recommends the modified definition described above.

According to the hearing record, the definition of assessed weight could be modified based on a recommendation of the committee and approval by the Department through the public rulemaking process. Witnesses supported this authority so the industry would be able to take advantage of any better standard developed to determine the assessable weight of pistachios received by handlers.

''Certified pistachios'' should be defined to mean those pistachios for which aflatoxin inspection certificates and minimum quality certificates have been issued. Under the provisions of the proposed order, California pistachios shipped for domestic human consumption would be required to be certified. The definition of ''certified pistachios'' is further discussed under material issue 5(d) related to proposed quality (including aflatoxin) requirements.

''Committee'' should be defined to mean the administrative committee, which would be established pursuant to the proposed provisions of § 983.32. The Act authorizes USDA to appoint an agency or agencies to assist in the administration of a marketing order program. This definition would identify the agency to locally administer the proposed pistachio order. The committee would be comprised of eight pistachio producers, two handlers, and one public member. The establishment of a committee would be important to ensure representation of the industry and consumers to USDA.

''Confidential data or information'' should be defined to mean reports and records furnished or submitted by handlers to the committee which include data or information constituting trade secrets or disclosing the trade position, financial condition, or business operations of a particular handler or its customers. This term is relevant to proposed § 983.48 pertaining to disclosure of handler information. The confidentiality requirements in that provision of the order, discussed under material issue 5(e) are consistent with those contained in the Act.

''Department'' or ''USDA'' should be defined to mean the United States Department of Agriculture, which is the governmental body responsible for oversight of Federal marketing orders and agreements. This definition allows the usage of the USDA acronym, or reference to the USDA as the Department throughout the language of the proposed order.

''District'' should be defined to mean each geographic subdivision of the proposed production area described in the marketing order. The district delineations defined would be important for the purposes of committee nominations and producer representation of the regional areas of the production area.

The record supports dividing the production area into three districts. District 1 would consist of 11 counties in Southern California (Tulare, Kern, San Bernardino, San Luis Obispo, Santa Barbara, Ventura, Los Angeles, Orange, Riverside, San Diego, and Imperial Counties). District 2 would be comprised of four counties in Central California where pistachio production is most highly concentrated (Kings, Fresno, Madera, and Merced Counties). District 3 would consist of the remaining 43 California counties, primarily in the Northern portion of the State. The record shows that dividing the production area into these three districts would provide for adequate producer representation on the committee.

Allocation of producer membership among the districts would be based, in large part, on the relative levels of acreage and production among the districts, as well as the number of producers in each of the districts. Allocation of producer membership among the districts is discussed further under material issue 5(b).

Testimony indicated that authority should be provided to allow the committee to recommend to USDA the re-establishment of district boundaries and reapportionment of producer membership among the districts. This would allow changes in producer representation on the committee to reflect any future shifts in pistachio acreage and production within the production area.

Witnesses also stated that district changes under the California Pistachio Commission should be a criterion used in adjusting the district boundaries under the proposed order. It may be reasonable to assume that changes in the distribution of pistachio producers, acreage and production would justify district reestablishment under both the State and Federal programs. However, any recommended change in the district boundaries under the order would be evaluated on its own merits.

The definition of ''district'' contains authority to reestablish district boundaries. Redistricting would require a recommendation of the committee and approval by USDA through the rulemaking process. Authority for reallocation of producer membership among the districts is contained in proposed § 983.32 and is discussed later in this document.

''Domestic shipments'' should be defined to mean shipments to the 50 United States and to the territories of the United States. This term is important as the proposed quality requirements (including those pertaining to aflatoxin and size) would only apply to domestic shipments. The proposed quality requirements would not apply to exports. The regulatory text of proposed § 983.12 is recommended to be modified from what appeared in the Notice of Hearing to include shipments to the District of Columbia as domestic shipments. Omission of Washington, DC as a domestic market was an oversight on the part of the proponent group, and its inclusion in the order is consistent with the record evidence.

''Edible pistachios'' should be defined to mean pistachios that meet the quality requirements (including those pertaining to aflatoxin and size) set forth under the proposed provisions of § 983.38, ''Aflatoxin levels,'' and § 983.39, ''Minimum quality and size levels.'' In particular, edible pistachios are pistachios that have been certified that they do not exceed the maximum level for aflatoxin and that they meet the minimum requirements for shell and kernel quality (including those relating to size).

''Inshell pistachios'' should be defined to mean pistachios that have a shell that has not been removed. This is to distinguish an inshell pistachio from a pistachio kernel or shelled pistachio. This term is further discussed in the context of proposed order provisions relating to quality standards under material issue 5(d).

''Inspector'' should be defined to mean any inspector authorized or approved by the USDA to inspect pistachios. This term is used in connection with the quality requirements proposed to be included in the order. An inspector, for example, would pull samples for aflatoxin testing by accredited laboratories. Inspectors would also be responsible for inspecting and certifying that pistachios meet the other quality requirements of the order.

The record shows that the Federal or Federal-State Inspection Service would be designated as the agency responsible for conducting these activities. To provide maximum flexibility, however, the order should provide that any inspector so authorized or approved by the Department may perform these functions.

''Lot'' should be defined to mean any quantity of pistachios that is submitted for testing for certification under the minimum quality requirements (including aflatoxin and size) of this proposed order. Specifically, a ''lot'' would be an identifiable quantity of pistachios handled by a handler at one time. A lot could have common characteristics, such as origin, type of packing, packer, consignor, or markings.

The record shows that the definition of lot is important in the context of traceability, as each lot tested would be issued a unique identification number. Traceability would allow handlers to respond to any sub-quality or aflatoxin issues that would necessitate preventing pistachios from entering the stream of commerce. The definition of ''lot'' is further discussed under material issue 5(d) in connection with the testing and certification provisions contained in proposed §§ 983.38 and 983.39.

''Minimum quality requirements'' should be defined to mean those requirements specified under the proposed provisions of § 983.39, which prescribe the permissible maximum defects and minimum size for inshell pistachios and pistachio kernels handled and shipped from and within the proposed production area. Regulation of quality is central to the proposed marketing order. This term is further discussed under material issue 5(d).

In conjunction with the definition of minimum quality requirements given above, ''minimum quality certificate'' should be defined to mean a certificate issued by an inspector that would indicate that a lot of pistachios was tested for the quality requirements proposed in this order and whether it met those requirements. Under the provisions of this program, no handler could ship pistachios for domestic human consumption that exceeded the percentage of defects or small-sized nuts allowed under § 983.39. Witnesses explained that any handler placing California pistachios into the stream of domestic commerce for the purpose of human consumption would be required to obtain a minimum quality certificate to this effect. Therefore, minimum quality certificates are also important to the committee record-keeping and auditing responsibilities.

''Part'' should be defined to mean the order regulating the handling of pistachios grown in the State of California, and all rules and regulations issued under the order. The order itself would be defined as a subpart of the part, as would individual rules and regulations.

According to record evidence ''person'' should be defined to mean an individual, partnership, limited liability corporation, corporation, trust, association, or any other business unit. This definition is consistent with the definition contained in the Act.

''Processing'' should be defined to mean hulling and drying of pistachios grown in the production area in preparation for market. This term covers the first steps of the handling process that occurs after the pistachios are harvested.

Witnesses describing the assessment collection aspects of the proposed order explained that handler assessments would be based on the volume of pistachios initially received from the field. Record evidence suggests that it is important to differentiate between processing activities and further preparing pistachios for market, as different handlers may perform these different functions. That is, one handler may perform the initial handling function of processing (hulling and drying), while another handler performs the remaining steps in the handling process.

Witnesses stated that only those handlers conducting the initial processing activities would be responsible for paying assessments to the committee. This would preclude the same pistachios from being assessed more than once. This term is included in the discussion of proposed § 983.53, ''Assessments'' which appears under material issue 5(c).

''Producer'' should be defined to identify those persons who are eligible to vote for, and serve as, producer members and alternate members of the committee, and those who are eligible to vote in any referendum. The term should mean any person engaged within the production area in a proprietary capacity in the production or growing of pistachios for sale.

Each business unit (such as a corporation or partnership) should be considered a single grower and should have a single vote in nomination proceedings and referenda. The term ''producer'' should include any person who owns or shares in the ownership of pistachios. For example, a person who rents land and produces pistachios resulting in that person's ownership of all or part of the pistachios produced on that land would be considered a producer.

Also, any person who owns land, which that person does not farm, but as rental for such land obtains ownership of a portion of the pistachios produced thereon, should be regarded as a producer for that portion of the pistachios received as rent. The tenant on such land should be regarded as a producer for the remaining portion produced on such land.

A joint venture is one whereby several persons contribute resources to a single endeavor to produce and market a pistachio crop. In such venture, one party may be the farmer who contributes one or more factors such as labor, time, production facilities or cultural skills, and the other party may be a handler who contributes money and cultural, harvesting, and marketing supervision. Normally, a husband and wife operation would be considered a partnership. Any individual, partnership, family enterprise, organization, estate, or other business unit currently engaged in the production of pistachios for market would be considered a producer under the order, and would be entitled to vote in referenda and committee nominations. Each party would have to have title to at least part of the crop produced, electing its disposition, and receiving the proceeds there from. This control would come from owning and farming land producing pistachios, payment for farming services performed, or a landlord's share of the crop for the use of the producing land. A landlord who only receives cash for the land would not be eligible to vote. A business unit would be able to cast only one vote regardless of the number and location of its orchards, but each legal entity would be entitled to vote.

''Production year'' should be defined to mean the period beginning on September 1st and ending on August 31st of each year, or such other period as may be recommended by the committee and approved by the Department. This period starts with the typical beginning of the harvest season for pistachios and would prescribe a period of conduct for the committee's administrative activities, such as preparing an annual budget of expenses and accounting for receipts and expenditures of funds. Thus, the term ''production year'' would be synonymous with the term ''fiscal period.''

Witnesses at the hearing also supported the September 1 through August 31 period because it coincides with the California Pistachio Commission's accounting year. Having the same fiscal periods could facilitate the joint management of the two programs, which could yield administrative efficiencies to the industry's benefit.

As discussed under material issue 5(c), assessments would be based on the volume of pistachios received by a handler in each production year. Witnesses at the hearing stated that, although rare, there are some instances when pistachio harvest begins earlier than September 1. Record evidence suggests that this has happened in 2 out of the past 10 production years. In an effort to reconcile potential accounting differences within the context of the proposed Federal program, witnesses suggested that any pistachios harvested as much as four weeks earlier than the beginning of September be attributed to the new year's production total. Thus, this definition would also state that pistachios harvested and received in August of any year would be counted as part of the subsequent production year for assessment and other marketing order purposes. The inclusion of pistachios harvested and received within four weeks prior to September 1 represents a modification of the order language contained in the Notice of Hearing.

''Proprietary Capacity'' should be defined to mean the capacity or interest of a producer or handler that, either directly or through an intermediary, is a property owner together with the rights of an owner including the right to vote the interest in that capacity as an individual, shareholder, member of a cooperative, partner, trustee, or in any other capacity with respect to any other business unit.

Witnesses explained that this term is important to the proposed order and its provisions in that this language would make persons who are sharing ownership of a common business entity ''affiliated'' (see previous definition) for purposes of eligibility to serve on the committee. The term ''proprietary capacity'' is intended to imply ownership of a business as compared to an employee status only.

''Secretary'' means the Secretary of Agriculture of the United States or any officer or employee of the United States Department of Agriculture who is, or who may hereafter be, authorized to act in the Secretary's stead. The term includes any other officer or employee of the United States Department of Agriculture who has been delegated or who may be delegated the authority to act on behalf of the Secretary.

''Shelled pistachio'' should be defined to mean a pistachio kernel or part thereof and is distinct from an ''inshell pistachio.'' This term is relevant to the discussion of quality requirements set forth in proposed §§ 983.38 and 983.39, ''Aflatoxin levels'' and ''Minimum quality levels,'' and proposed §§ 983.40 and 983.43, ''Failed lots/rework procedures'' and ''Reinspection.''

''Substandard pistachios'' should be defined to mean shelled or inshell pistachios that do not meet the proposed quality requirements (including those related to size and aflatoxin) of the proposed order. According to the record, substandard pistachios should not be marketed for domestic human consumption. The proposed order contains specific provisions regarding the disposition of substandard pistachios. These provisions appear in proposed §§ 983.40 and 983.43, ''Failed lots/rework procedures'' and ''Reinspection,'' and are discussed under material issue 5(d).

Material Issue Number 5(b)—Administrative Committee

Pursuant to the Act, it is necessary to establish an agency to administer the order locally and to provide for effective and efficient operation of the order. The establishment and membership of an administrative committee is addressed in §§ 983.32 and 983.33 of the proposed order.

The hearing record shows that the committee should consist of 11 members. Eight members should be producers, two members should be handlers, and one member should be selected from the general public. Each member should have an alternate member who, possessing the same qualifications as the member, could serve in that member's place and stead in the event that the committee member could not fulfill his or her duties.

Allocation of Producer Membership

For the purpose of producer representation, the proposed order provides that the production area be divided into three districts. District 1 would consist of Tulare, Kern, San Bernardino, San Luis Obispo, Santa Barbara, Ventura, Los Angeles, Orange, Riverside, San Diego and Imperial Counties. District 2 would consist of Kings, Fresno, Madera, and Merced Counties. District 3 would consist of all other Counties in California not included in Districts 1 and 2.

As mentioned previously, the record indicates that producer representation from each district should be based, in large part, on the relative number of producers, bearing acreage, and volume of production in each district. According to record evidence, District 1 had 227 producers, 38,396 acres, and production totaling 95,889,846 pounds in 2001. This represents 35 percent of the total number of California pistachio producers (647), 49 percent of the State's bearing acreage (78,000) and 60 percent of total production in 2001 (160,295,282 pounds). District 2 had 358 producers (55 percent) and 36,330 acres (47 percent), and produced a total of 57,453,864 pounds (36 percent) in 2001. District 3 had 62 producers (10 percent), 3,274 acres (4 percent) and 6,951,572 pounds of production (4 percent).

Given the relative volumes and to ensure that each district's producers are represented on the committee, witnesses testified that of the eight producer members, four should be from District 1, three should represent District 2, and one should be a pistachio grower in District 3.

As discussed under material issue 5(a), § 983.11 of the proposed order (which defines the three districts) should contain authority for the reestablishment of those districts. This would enable producer representation on the committee to reflect any future shifts in pistachio production among the districts.

The record also supports authority for reapportionment of producer membership among the districts. This authority would complement the authority to reestablish districts, and would serve to allow for changes in representation in producer membership on the committee. Producer membership could be reapportioned whether or not the districts were reestablished. The record supports allowing producer membership to be reapportioned among the districts upon a two-thirds recommendation of the committee and approval of the Department (through the rulemaking process).

While the record supports the ability to reapportion producer membership, the proposed order as it appeared in the Notice of Hearing did not contain such a provision. USDA recommends adding language to § 983.32(b) of the proposed order to provide authority to reapportion producer membership among the districts.

Allocation of Handler Membership

While the record shows that producer representation on the committee should be allocated among geographic districts, such allocation is not needed for the two handler members on the committee. The two handler members would represent the production area-at-large. For one of the handler members, each pistachio handler would be entitled to cast one vote in the nomination process. For the second handler member, each pistachio handler would be entitled to cast one vote for each ton of assessed weight of pistachios processed by that handler during the two production years preceding the year in which nominations are made.

The record shows that there are 19 pistachio handlers in California, and that 1 of these handlers accounts for more than half of the volume of pistachios processed in California each year. Under the proposed provisions of the order, one of the handler members would likely represent the largest handler in the industry, since voting in the nomination process for that member would be weighted by volume. All remaining handlers would then nominate the other handler member, since any one handling entity would not be eligible to fill both handler member positions. (This limitation is discussed below.) Witnesses supported this method of allocating handler membership as adequate to ensure appropriate representation of the interests of California pistachio handlers in committee deliberations.

In weighting the nomination votes for one of the handler members, the record shows that each handler would be entitled to cast one vote for each ton (or portion thereof) of assessed weight of pistachios processed by that handler during the two production years preceding the production year in which nominations are made. Calculating the assessed weight based on two years of production is intended to take into account the alternate bearing nature of pistachio trees. Furthermore, the assessed weight of pistachios would be credited to the handler responsible under the order for the payment of the assessments. This provision would address the fact that pistachios are often traded or sold by one handler to another after they are harvested. Attributing the volume of pistachios to the first handler of those pistachios would preclude double counting of nuts that are transferred from one handler to another. It would also provide the most accurate measure of the relative volumes of pistachios handled by each handler.

Witnesses at the hearing testified that all handlers currently process (hull and dry) pistachios. Thus, all handlers would be able to participate in the nomination of both handler members on the committee.

The record supports authority in the proposed order to revise handler representation on the committee to ensure that industry representation remains appropriate. This provision would allow for flexibility in the order to accommodate for future changes in industry structure. For example, if a significant number of handlers in the industry ceased to process pistachios, it could be appropriate to weight their votes in the nomination process on some other basis than the assessed weight of pistachios. Any change in handler representation would require a recommendation by the committee and approval by USDA through the rulemaking process.

Committee Member Affiliations

The order should provide that not more than two members of the committee, and not more than two alternate members, could be employed by or affiliated with the same handler and/or producer. Additionally, only one producer member and alternate in any one district and only one handler member and alternate could be affiliated.

The record evidence is that the membership of the committee should be representative of the industry as a whole. No one group of people who share common business interests should be able to gain control of committee decision making. To accomplish this goal, the order should limit the number of positions the members of any one affiliated group could hold.

As previously mentioned, one handler in the industry accounts for more than half of the California pistachios handled annually. The record shows that the two-member limitation is in large part intended to prevent any entity, and its many affiliates, from dominating committee actions. The limitation is designed to assure fair representation on the committee, given the current nature and structure of the California pistachio industry.

As discussed under Material Issue 5(a), the term ''affiliation'' should be defined broadly so that it encompasses the many different relationships through which people have common business interests.

Witnesses at the hearing gave several examples to illustrate their view of how this limitation on committee membership should work. In the case of a corporate handler, all of its shareholders should be considered an affiliated group because they would be connected in a proprietary capacity and share in the ownership and control of the corporate handler. In this scenario, the shareholders and employees of the corporation would be limited to one handler member on the committee; they could not hold both handler member positions. If the corporation was also a pistachio producer, a producer member could also represent the affiliated group. In no case could more than two committee members represent that affiliated group.

Another example offered by witnesses described one corporation owned by one set of shareholders and a second corporation with a separate set of shareholders that jointly own a handling entity. In this case, the employees of the handling entity and both of the corporations, and both sets of shareholders, would be considered as one affiliated group. As such, this combination of two corporations and one handler would be limited to a maximum of two committee positions.

A third scenario described by witnesses entailed a corporation, owned by its shareholders, and a producer cooperative that jointly own a handling entity. The cooperative was comprised of producer members who grow pistachios and share in the proceeds of the sale of all of the pistachios of the members pooled together. In this case, the corporation (owned by its shareholders) and the cooperative (owned by its members) would be affiliated through their common control of the handler. Therefore, this combination of corporate employees and shareholders, cooperative employees and members, and handler employees, would constitute a single affiliated group. The entire group would be entitled to no more than two representatives on the committee.

Witnesses also testified about a producer who sells pistachios to a handler for cash or a fixed price plus bonuses but has no ownership or proprietary interest in that handler. In such a case, the producer would not be affiliated with that handler for purposes of committee membership.

In a final illustration, if a producer is a shareholder or a member of, or directly or indirectly owns a handler, that producer would be considered a part of the handler's affiliated group. This would be true even if that producer sells part of his or her crop to another handler that is not part of the affiliated group.

Cooperative Affiliation

As discussed above, members of a producer cooperative would constitute an affiliated group for purposes of committee membership. The record shows that the order should contain a provision to clarify when a person ceases to be affiliated with a cooperative for those purposes.

As explained for the record, cooperatives usually retain from their profits, which would otherwise be paid pro rata to its members, such amount as is needed for its capital needs and reserves. These ''retains'' are allocated and then paid pro rata to each member whenever the capital needs change or are replaced by new retains in subsequent years. This is known as ''revolving capital.''

Paragraph (f) of proposed § 983.33 should provide that a producer who has not marketed pistachios through a cooperative during the current and one preceding production year would no longer be considered ''affiliated'' with that cooperative. This would be true even if the cooperative continued to hold that producer's retains. If the cooperative holds none of the producer's retains, that producer would become unaffiliated with that cooperative at the time his or her membership is terminated.

The record supports an additional clarification concerning producer cooperatives. There may be an occasion where a producer cooperative has, as a member, another producer cooperative that handles pistachios. While the members of both cooperatives would be considered affiliated, the producer cooperatives would still qualify as producers for purposes of voting for producer members on the committee.

Qualifications of the Public Member

At the hearing, witnesses supported having a public member on the committee. The appointment of a public member would offer many advantages. One such advantage would be that the committee would have an impartial individual, having no economic interest in the pistachio industry, with whom to discuss industry problems and concerns. Such a person could offer a unique perspective in committee deliberations.

As such, witnesses recommended that the public member and alternate public member should not be permitted to have a financial interest in the production, processing, financing, buying, packing, or marketing of pistachios, except as a consumer. This member and his or her alternate would also be precluded from being a director, officer, employee or affiliate of any firm or business entity engaged in the pistachio industry. The public member should be willing to devote sufficient time to regularly attend committee meetings and become familiar with the background and economics of the industry, as well as the provisions of the proposed order. Testimony indicated that the committee could be able to establish (with the approval of USDA) further qualifications the public member and alternate member should possess, if deemed necessary.

Nominations

For the proposed committee to function, a mechanism is required by which members and alternate members would be nominated by their peers, and selected and appointed by the Department. Nomination procedures are set forth in the proposed provisions of §§ 983.32 and 983.33.

The order should provide that USDA would conduct nominations for initial producer and handler members of the committee. Such nominations could be made either at industry meetings, or by mail. The provisions also state that the first nominees must meet the same qualifications as required for their successors. While the Department would have discretion in determining a reasonable process to conduct initial committee nominations, the committee should be established as provided in § 983.22 of the proposed order.

A revision in paragraph (a) of § 983.33 is recommended. This revision would clarify that USDA would conduct the initial nominations of producer and handler members and alternates only. The initial public member and alternate would be nominated by the industry members of the committee, as described later in this document.

Successor Producer and Handler Members

The record evidence is that the committee staff should conduct subsequent nominations for producer and handler members of the committee. To facilitate maximum participation in the process, nominations would be conducted by mail ballot.

The record evidence shows that producer and handler member nominations would entail several steps. First, individuals seeking nomination would be required to establish their qualifications to serve as a California pistachio producer or handler, and to identify the district (for producer seats) they are seeking to represent. Candidates would also be required to identify whether they intend to seek nomination as a producer or handler member. Considering that many pistachio handlers are also producers, witnesses recommended that individuals be limited to seeking nomination as one or the other. In other words, the same individual would not be allowed to simultaneously seek a producer and a handler seat; his or her name could only appear on the producer or the handler ballot, not both.

The record shows that individuals seeking to fill member seats would need to submit notice of their intent to run as a nominee to the committee in advance of nominations. This would allow the committee staff adequate time to determine a candidate's eligibility in advance of issuing nomination ballots, and would allow for any questions or informational needs to be addressed in advance of voting for nominees.

Once qualified candidates are identified, ballots containing the names of those individuals and additional space for write-in candidates would be prepared. The ballots, together with voting instructions, would be mailed to all producers and handlers who are on record with the committee. The committee staff would tally the votes and submit its nomination report to USDA for selection.

The hearing record supports the same general approach for nominations of both producer and handler members. However, the language contained in the Notice of Hearing did not include provisions specific to successor handler nominations. USDA is suggesting that proposed § 983.33(b) be modified accordingly.

The record shows that the committee should have authority (with USDA approval) to establish additional rules and regulations governing the nomination process, if deemed necessary. This authority would apply to both producer and handler member nominations.

Producer Members

Witnesses explained that individuals seeking candidacy for nomination to a producer seat would be required to designate the district in which they seek election and substantiate their qualification as a producer, or designated representative of a producer, in that district. However, testimony also clarified that the order would not require that the candidate be a resident of that district. Witnesses explained that it would not be reasonable to impose such a requirement since not all producers live in the same district in which they produce pistachios. Such a residency requirement would, therefore, preclude a number of pistachio producers from being able to serve on the committee.

Record evidence states that only producers would be qualified to serve as producer members and to participate in the nomination of producer members and their alternates. Producers can be corporations, partnerships, limited liability companies, trusts or other legal entities, as well as a sole proprietorship owned by an individual. The owners of the pistachio groves could designate an officer or employee to seek membership and to cast the votes on their behalf. As proposed, officers and employees would not include professional farm managers who perform farm management services for a number of different producers without being an employee or an officer of the producer. The intent is to limit those eligible to serve as producer members to persons who are involved, either as a producer with a proprietary interest in the pistachio industry or an employee working in the industry for a producer.

Each producer would be entitled to cast one vote, either in person or through an authorized officer or employee, for each producer member position to be filled in his or her district. Witnesses suggested that rules and regulations could be recommended by the committee and approved by the Department that would require such authorization to be in writing and to be addressed to the committee. A producer would only be able to cast his or her vote in the district in which that producer produces pistachios. If the producer were engaged in producing pistachios in more than one district, then the producer would need to select a district in which to participate as a nominee and/or as a voter. A producer would not be allowed to vote for candidates in more than one district.

Producers receiving the highest number of votes in each district would be designated nominees for their respective districts. Alternates for each nominee would be the candidates receiving the second highest number of votes in the same district. In the case of a tie, witnesses recommended that final nominees and their alternates be selected by a drawing.

Handler Members

Handler nominees would be selected for the production area as a whole, and final candidates would be determined based on those two individuals receiving (1) The most votes representing handlers by number, and (2) the most votes representing handlers by volume. Alternates would be designated as those individuals receiving the second highest vote in each respective category. Handler voting procedures are further described below.

Record evidence specifies that only handlers could participate in the nomination of the handler members and their alternates. Handlers would include the duly authorized officers or employees of handlers. Since many of the handlers are incorporated, a corporation or other business entity would be required to designate its representative. Individuals could also designate an employee to act on behalf of the proprietorship through a written designation signed by the owner.

As indicated above, handler representation would be divided into two categories, with one member nominated by a number vote and the other member nominated by a volume vote. The former would be nominated by receiving the highest number of votes placed by voting handlers, with each handler having one vote. That member's alternate would be the candidate receiving the second highest number of votes.

The provisions of the proposed order provide that if a person were both a producer and a handler of pistachios, that person would be able to participate in both the producer and handler nominations. While a single individual may not hold more than one seat on the committee, a producer who is also a handler could designate an officer or employee as a handler nominee, and another representative as a producer nominee. The affiliation provisions described above would apply.

Members of the committee, at the time of their selection and during their term of office, must be pistachio producers or handlers, or officers or employees of a producer or handler. If that relationship should terminate during their term as a committee member or alternate, that person would become disqualified to serve further, and the position would be deemed vacant.

Public Member

The provisions proposed under § 983.32(c) would govern nomination and selection of the public member and alternate member. According to the record, the public member, who would be neither a pistachio producer nor a handler, would have all the rights and responsibilities of any other member of the committee. The record evidence is that the producer and handler members of the committee should nominate the public member. Witnesses explained that industry committee members would be in the best position to identify individuals who are qualified and willing to serve. Once the committee identified possible public member and alternate public member candidates, the committee would make a recommendation to USDA for final approval and selection by the Department.

Alternate Members

The order should provide for the nomination and selection of an alternate member for each committee member. Alternates would be subject to the same eligibility requirements as committee members. They would act in the place and stead of the committee members they are alternates for when the committee members cannot fulfill their committee obligations. Alternates would provide continuity and stability to committee operations by ensuring full representation of the industry, including their particular district and group (producers or handlers).

Alternate members would be nominated in the same manner as committee members, except that the recommended alternate(s) would be the individual(s) receiving the next highest votes to the nominee(s) receiving the highest number of votes. If a person were selected as an alternate from the same district as a member and both are employed by or connected in a proprietary capacity with the same business entity, the alternate would serve as the alternate to that member.

When serving in the place and stead of their committee members, alternate members would be able to exercise all of the rights, duties and powers of those members as though they were serving as full members of the committee. Alternate members would only be allowed to vote in the absence of those members for whom they are alternates, or when they succeed to those members' positions.

Record evidence also shows that an alternate member should succeed his or her member in the event of that member's death, removal, resignation or disqualification. The alternate would then serve until a successor was selected and qualified.

Selection by USDA

Record evidence states that once the nomination process for producer and handler members is completed, and the industry has voted on committee member and alternate candidates, nomination reports or committee minutes would be prepared by the committee staff and sent to the USDA. This should be done at least 60 days prior to the beginning of each two-year term of office (or by May 1). The Department, after determining that the conditions and qualifications of each nominee have been met, would then select the 10 producer and handler members of the committee and an alternate for each of those members based upon the nominations.

As previously mentioned, the newly appointed industry members of the committee would nominate the public member and alternate member. USDA would also be responsible for selecting the public member and alternate.

Nominees would be required to indicate in advance of their selection that they are willing to accept the position for which they were nominated. Agreeing in advance to serve as a committee member or alternate would avoid possible delays in the appointment of the committee.

In the event that nominations are not made within the time and manner specified in the order, the USDA could appoint members and alternates without regard to nominations. Those appointments would be made on the basis of representation provided in proposed §§ 983.32 and 983.33.

Term of Office

Record evidence suggests that the term of office should begin on July 1 and last for 2 years. The month of July represents a natural break in the California pistachio production cycle, with each new harvest beginning typically in September, or at the earliest in August. Moreover, witnesses indicated that this time frame would allow adequate time for committee members and staff to prepare an annual budget, develop a marketing policy for the upcoming production year, and make any recommendations to the Department for any needed regulatory changes prior to harvest activities.

In addition, witnesses at the hearing indicated that terms should be staggered so that approximately half of the committee members' positions would be filled each year. This provision would ensure that continuity in experience among committee members was maintained, yet provide for new members with new ideas and fresh perspectives to participate in the administration of the order. To initiate this process, witnesses recommended that the first committee members nominated would be divided into two groups by a drawing to determine whether they would be seated for initial terms of one year or two years. Four producer members, one handler member and their alternates would serve an initial term of about one year. Remaining industry members and the public member (and their alternates) would serve an initial term of about 2 years.

The regulatory text contained in the Notice of Hearing failed to specify that the term of office should apply to all committee members and their alternates. Paragraph (k) of proposed § 983.33 has been revised to correct this.

Term Limits

Record evidence supports term limits to spread the involvement of the pistachio producers and handlers, and increase industry participation in administering the marketing order. Term limits should apply to all committee members and alternates, including those representing the public. The maximum number of terms that an individual would be allowed to serve for would be four consecutive two-year terms of office, or a maximum of eight consecutive years on the committee. The tenure requirements would apply to both committee members and alternate members. Once a person has served as a member and/or alternate for 8 years, that person would not be eligible for renomination. He or she would be eligible to serve again after 12 consecutive months out of office.

Vacancies

Any vacancy on the committee would be filled by a majority vote of the committee members remaining for the remaining unexpired term of the vacant position. This authority appears in paragraph (j) of proposed § 983.33. The replacement must fulfill all of the qualifications set forth as required for any other nominee for the position, and that person's qualifications would have to be certified to USDA. The Department could then appoint the nominee to serve the balance of the term.

This procedure would eliminate the need to conduct a special nomination to fill a vacancy for the balance of a term, which would be less than two years in any case. It would also serve to address situations in which a member's position is vacant and the alternate declines the position or is not available to fill the vacancy, as provided in proposed § 983.33(g). The authority could also be used to fill a vacancy for an alternate member.

Proposed Quorum and Voting Provisions

The record evidence is that once the committee is appointed, a quorum of the committee would consist of seven committee members. This would include handlers, producers and the public member. Except as discussed below, any action of the committee would require the concurring vote of a majority of the committee members present. An alternate could serve as a member for purposes of constituting a quorum and voting if the member is absent.

Record evidence indicated, however, that certain issues are of sufficient significance to the industry that action should require a greater degree of consensus than a simple majority vote would demonstrate. Witnesses testified that there are four areas that should require at least seven concurring votes, prior to any recommendation being made to the USDA. The first involves any modifications of the minimum quality levels set forth in proposed § 983.39. The second entails any change in the aflatoxin levels prescribed in § 983.38 of the proposed order. Adjustments in the sampling and inspection requirements included in the order with respect to minimum quality (including aflatoxin) requirements is another area that should require seven concurring votes. And, finally, the record indicates that recommendations related to changes in committee representation (including qualifications and affiliation issues) should require a higher level of committee member agreement.

As such, this proposal provides that any recommended change or modification to the issues outlined above would require at least seven concurring votes. Any other actions by the committee could be determined by a simple majority of those voting.

The record shows that at committee meetings, members could cast their vote by voice or in writing. Participation by telephone would be permitted as long as the equipment used would allow all meeting participants to hear and communicate with each other. Telephone or similar communication equipment could include conference call equipment and/or audio-visual equipment that would allow all members to participate in a meeting simultaneously.

If for some reason an action must be taken without a meeting, record evidence indicates that such action would require a unanimous vote of the committee, and the votes would have to be in writing. Witnesses testifying at the hearing stated that the types of committee actions contemplated without a meeting would be limited to issues of routine business or those of relatively minor importance, such as approval of meeting minutes. Such matters would not merit the time and expense of holding an assembled meeting. This proposed provision is common to several existing marketing orders and would enhance the committee's decision-making abilities on simple administrative matters.

Compensation

While testimony supported reimbursement of necessary expenses incurred by committee members attending meetings, witnesses testified that no compensation should be made to pistachio producers and handlers for their service on the committee. To the extent the committee requested the attendance of alternate members, those alternates would also be entitled to reimbursement of their expenses.

Record evidence did support compensation, in addition to the necessary expenses, of the public member. In order to get the level of experience and background required to serve as a qualified, effective public member, witnesses stated that it might be necessary to compensate that person for his or her time. Compensation would need to be set at a reasonable level, and should be consistent with that person's experience and background.

Committee Powers and Duties

The committee, under proposed § 983.35, should be given those specific powers that are set forth in section 608c(7)(C) of the Act. Such powers are necessary for an administrative agency, such as the proposed committee, to carry out its proper functions. According to record evidence, the committee would have four general powers under the proposed provisions of this order:

(1) To administer the provisions of the order;

(2) To adopt by-laws, rules, and regulations for the implementation of the order with the approval of the Department;

(3) To receive, investigate, and report to the Department complaints regarding violations of the order; and

(4) To recommend marketing order amendments to the Department.

These powers are necessary to carry out the committee's functions under both the proposed order and the Act. Witnesses indicated that these powers would enable the committee to make recommendations to the Department that reflect the conditions in the industry from their knowledge and experience.

The specific duties of the committee as set forth in § 983.36 of the proposed order are necessary for the discharge of its responsibilities. These duties are similar to those typically specified for administrative agencies under other marketing order programs. They pertain to specific activities authorized under the order, such as investigating and compiling information regarding California pistachio marketing conditions, and to the general administration of the program including hiring employees, appointing officers, and keeping records of all committee transactions. The proposed order delineates the committee's duties as follows:

(1) The committee should adopt bylaws and rules for the conduct of its meetings and for such other purposes as it deems necessary. The committee should also select such officers from among its membership, including a chairperson and vice-chairperson, as may be necessary, and define the duties of such officers.

(2) The committee should employ such persons as it deems necessary to effectively and efficiently operate the program. The committee could enter into contracts or agreements with such persons, determine their duties, and establish appropriate levels of compensation. Such contracts or agreements would pertain to the provision of services required by the order and for the payment of the cost of such services with funds collected under the order.

(3) The committee should select such subcommittees as may be necessary.

(4) The committee should submit to the USDA a budget for each fiscal period, prior to the beginning of such period. The budget submission should include a report explaining the budget items and the committee's recommendation as to the rate of assessments for the fiscal period.

(5) The committee should be required to keep minutes, books, and records that reflect all of the acts and transactions of the committee. Such records would be subject to examination by the Department.

(6) The committee should prepare periodic statements of the financial operations of the committee and make copies of each statement available to producers and handlers for examination at the office of the committee.

(7) The committee should be required to have its financial statements audited by a certified public accountant at least once each fiscal year and at such times as the USDA may request. Such audits should include an examination of the receipt of assessments and the disbursement of all funds. The committee should provide USDA with a copy of all audit reports and should make copies of such audits, after the removal of any confidential individual or handler information that may be contained in them, available for examination at the committee's office.

(8) The committee should act as an intermediary between USDA and any pistachio producer or handler with respect to the operations of the order.

(9) The committee should investigate and assemble data on the growing, handling, shipping and marketing conditions with respect to pistachios.

(10) The committee should be required to apprise the Department of all committee meetings in a timely manner.

(11) The committee should be required to submit to USDA such available information as the Department may request.

(12) The committee should have the duty to investigate compliance with the provisions of the order.

(13) The committee should provide, through communication to producers and handlers, information regarding the activities of the committee. The committee should also respond to industry inquiries about committee activities.

(14) The committee should oversee the collection of assessments levied under the order.

(15) Finally, the committee should have the authority to borrow such funds as may be necessary to fulfill its responsibilities and obligations. Any loan would be subject to USDA approval and could not exceed the expected expenses of one fiscal year.

Witnesses explained that the above-outlined duties are important to the efficient and functional operation of the committee.

Material Issue Number 5(c)—Expenses and Assessments

The committee should be required to prepare a budget showing estimates of income and expenditures necessary for the administration of the marketing order during each fiscal year. The budget, including an analysis of its component parts, should be submitted to USDA sufficiently in advance of each fiscal period to provide for USDA's review and approval. The budget should also include a recommendation to USDA of a rate of assessment designed to secure income required for such fiscal year.

The committee should be authorized under § 983.52 of the proposed order to incur such expenses as the Department finds are reasonable and likely to be incurred during each fiscal, or production, year. Such a provision is necessary to assure the maintenance and functioning of the committee, and to enable the committee to perform its duties in accordance with the provisions of the order.

The record states that funds to cover the committee's expenses would be obtained through the collection of assessments from handlers who process pistachios in the proposed production area. These assessments are intended to reflect each handler's proportional share of the committee's expenses. As such, assessments would be based on the total amount of pistachios processed by each handler relative to the total amount of pistachios processed by the industry as a whole during a given production year.

Witnesses explained that since pistachios are often transferred between handlers for further preparation or packaging for market, it would be appropriate to apply assessment calculations to the handler who first handles a particular lot of pistachios. By assessing the handler who initially receives a lot of pistachios, the industry intends to prevent having assessments paid more than once for the same pistachios. The previous discussion of the definition of ''assessed weight'' further clarifies this calculation.

Testimony in support of proposed § 983.52 covering committee expenses indicates that prior to the beginning of each production year, and as may be necessary thereafter, the committee should prepare an estimated budget of expenses necessary for its effective administration of the order. Based upon this estimate, the committee would calculate and recommend to the Department a rate of assessment that would provide adequate funds to cover the cost of projected expenditures. Preparing a budget for the committee prior to the beginning of each fiscal period is reasonable. A budget is necessary to provide the committee and the Department with a basis for determining the assessment necessary to cover the cost of operation.

The committee would present its annual budget to USDA for review and approval. Accompanying the budget would be a report showing the basis for its calculations, an explanation of each line item, and any proposed year-over-year increases or decreases. Assessments would be levied at the rates established by USDA. Establishment of such assessment rates would be accomplished through the informal rulemaking process. Such rates would be established on the basis of the committee's recommendations or other available information.

Witnesses stated that any assessment rate recommended to the Department should be limited to a maximum rate of one half of 1 percent of the industry's previous production year's average producer price. The average producer price would be calculated by the committee and would be based on the previous year's average grower receipt per pound of pistachios.

The record shows that recent producer prices for pistachios were around $1.10 per pound. If the average producer price calculated by the committee for the previous year was $1.10 per pound, the maximum assessment rate for the current year's crop would be $0.0055, or approximately one half a cent per pound. Applying this rate to 2001 production of about 160 million pounds would yield a maximum assessment income of $880,000. Witnesses testified that this should be sufficient to operate the proposed program.

The intent of the maximum limit on the assessment rate is to assure pistachio producers and handlers that program expenses would be kept within specified limits, and that no projects requiring extraordinary expenditures would be undertaken. The proposed limit appears reasonable for the administration of a program of this nature.

Witnesses reasoned that there could be times during a fiscal period when it would become necessary to revise the budget and/or increase the assessment. Such instances could include situations where actual harvest is lower than anticipated or the committee incurs unforeseen expenses. In this regard, witnesses stated that the assessment rate should not be increased without the committee first making a recommendation and securing approval of the Department to do so. Such recommendation would also need to be made prior the issuance of that production year's final handler assessment bill. Any assessment increase would be applicable to all pistachios received and processed by handlers within the proposed production area for that production year.

During the hearing, questions were raised regarding proposed order language contained in the Notice of Hearing. Language in the Notice provided that any change to the assessment rate would be required to be recommended and approved before October 1 of any production year and before the date established for payment of the assessment. Discussion at the hearing resulted in witnesses acknowledging that situations could arise where these deadlines would be too restrictive, and would prevent the committee from being able to address unforeseen shortfalls in assessment income.

Accordingly, witnesses recommended that the committee, as necessary, be permitted to adjust the rate of assessment (with USDA's approval) at any time before the final billing is made for the assessment. Section 983.53(b) should therefore be modified by removing the October 1 deadline and clarifying language that would allow the committee to recommend changes to the assessment rate before the issuance of the last handler assessment billing statement.

Record evidence in support of proposed § 983.55 indicates that if assessments are not paid within the time prescribed by the committee, the handler would be required to pay to the committee a late payment charge of 10 percent of the amount of the assessment determined to be past due and, in addition, interest on the unpaid balance at the rate of 1½ percent per month. Late payment charges and interest on unpaid balances are reasonable in encouraging timely payment of assessments and compensating the committee for expenses incurred in collecting unpaid assessments.

While supporters of this proposal indicated that any assessments imposed under the program would be quite modest, timely collection of those assessments would be important in order to efficiently and effectively administer the provisions of this proposed program. Moreover, they indicated that if one handler were to become delinquent in paying his or her assessments, this could serve as an incentive for others to also become delinquent. Witnesses felt that the proposed late payment and interest charges would help to ensure stability in the flow of committee funds collected through assessments.

The record evidence is that the committee should have the authority to recommend other rates for late payment and interest charges, as may be appropriate. Section 983.55 is being modified to clarify this point. Any change in these rates would require approval of the Department through the informal rulemaking process.

The Department is recommending several additional modifications in proposed § 983.55. The language contained in the hearing notice provided that in addition to delinquent assessments, late charges and interest would be imposed on handlers who fail to file required reports under the order. Since (in the case of unfiled reports) there would be no monetary value upon which to impose these charges, this provision is found unworkable and is therefore deleted.

Witnesses also supported a provision that if a handler is delinquent in paying his or her assessments for more than 60 days, the committee could request that the USDA stop providing aflatoxin and grade and size inspections to the delinquent handler. Witnesses also suggested that the committee could require any handler who fails to pay an assessment or related charge to furnish and maintain a surety bond in a form and amount, and for a period of time, specified by the committee. These provisions are not typical in relation to delinquent assessments under a marketing order program. Thus, these provisions are being deleted from § 983.55 of the proposed order. The Department would work with the committee staff in determining an appropriate course of action relating to violations of the proposed order, including nonpayment of assessments.

Under the proposed order, the committee would be allowed to accept voluntary contributions. Contributions could only be used to pay for authorized committee expenses. The committee may accept contributions, for example, to fund the operations of the order during the first part of a production year, before sufficient income is available from assessments on the current year's pistachios.

A section on accounting is necessary to assure handlers and the industry that funds would only be used for the purposes intended, that there would be a proper disposition of excess funds, and that a detailed accounting would be made of such disposition. Under the order, the committee would only be authorized to incur such expenses as USDA finds are reasonable and likely to be incurred by it during each production year for its maintenance and functioning, and for such other purposes as the Department may determine to be appropriate.

Paragraph (a) of proposed § 983.56 provides for situations where, at the end of the fiscal period, the assessments collected may be in excess of expenses incurred. According to record evidence, the provisions under this section would allow the committee, with the approval of the Department, to establish an operating monetary reserve. This would allow the committee to carry over to subsequent production years any excess funds in a reserve, provided that funds already in the reserve do not exceed approximately two years' expenses. If reserve funds do exceed that amount, the assessment rate should be reduced to bring the reserves to a more reasonable level. These reserve funds could be used to defray expenses during any production year before assessment income is sufficient to cover such expenses; to cover deficits incurred during any fiscal period when assessment income is less than expenses; to defray expenses incurred during any period when any or all provisions of the order were suspended or inoperative; and, to cover necessary expenses of liquidation in the event of termination of the program.

If any excess funds were not retained in a reserve, each handler who paid assessments would be entitled to a proportionate refund of the excess assessments collected. If excess assessments remained at the end of a given production year, the committee could apply each handler's excess as a credit for handlers towards the next production year's operating costs, or the committee could refund such funds to the handlers.

Testimony states that all funds received by the committee pursuant to the provisions of the proposed order would be used solely for the purposes specified in the order. Moreover, § 983.56 would authorize the Department at any time to require the committee and its members to account for all receipts, disbursements, funds, property or records for which they are responsible. This authority is necessary to ensure that proper accounting procedures are followed at all times.

Whenever any person ceases to be a member of the committee, that individual should be required to account for all receipts and disbursements for which he or she was responsible. That person should also be required to deliver all property and funds in such person's possession to the committee. Finally, that person would execute such assignments and other instruments as might be necessary or appropriate to vest in the committee full title of all committee property and funds.

In the event the proposed order were to be terminated or become inoperative, the committee, with the approval of USDA, would appoint one or more trustees for holding records, funds or other property of the committee. Any funds not required to defray the necessary expenses of liquidation would be returned, to the extent practicable, pro rata to the handlers from whom such funds were collected. Distribution of those funds would be carried out in a way that the Department deems appropriate.

Material Issue Number 5(d)—Quality and Inspection Requirements

According to record evidence, provisions regarding maximum aflatoxin levels, minimum quality levels (including size requirements), and testing and certification procedures should be included in the proposed order. These provisions are captured under the proposed §§ 983.38 through 983.46.

Presently, certain pistachio quality controls are in place under the California Pistachio Marketing Agreement (agreement). The agreement is effective under the California Marketing Act (Chapter 1, Part 2, Division 21 of the Food and Agricultural Code of the State of California). The regulations in effect under the agreement prohibit the blending of naturally and artificially opened pistachios; ban the practice of bleaching pistachios; and require mandatory aflatoxin testing for shipments to specified export markets. These regulations are voluntary in that they apply only to handlers who choose to sign the agreement. The record evidence is that signatories to the agreement current account for 82 percent of the pistachios produced in California.

The proposed Federal order would establish mandatory testing and certification requirements for California pistachios distributed for domestic human consumption. The order would include requirements that set maximum tolerance levels for aflatoxin and defects, and a minimum allowable size. The requirements under the proposed order would not duplicate or contradict the regulations under the State agreement.

According to the record, in preparation for this proposal, the California pistachio industry initiated a study group on pistachio quality assurance issues in May 2000. The purpose of this study group was to identify areas of quality regulation that would elicit consensus and support among industry producers and handlers. Record evidence also states that the proposed regulatory provisions are based on current industry practices and are substantiated by a wide body of scientific research and data.

Record testimony ties the industry's concern over the regulation of aflatoxin in pistachios to the protection of consumer interests by preventing the sale of contaminated nuts. Witnesses repeatedly cited evidence demonstrating consumers' reluctance to buying defective or damaged pistachios contaminated with mold. Consumer concerns about the presence or threat of aflatoxin in pistachios makes the regulation of aflatoxin bearing molds important.

Moreover, witnesses testified that if there were an outbreak of aflatoxin contamination in pistachios, widespread consumer reluctance to buy pistachios could result, even if the contamination was limited and quickly remedied. Witnesses feared that a single occurrence of aflatoxin contamination in pistachios could devastate the California pistachio industry and create effects that could take years and substantial financial resources to overcome.

Record evidence demonstrates the importance of regulating quality (including size) in tandem with aflatoxin, as research suggests a strong correlation between some sub-quality characteristics (for example, ''early-split'' pistachio nuts) and the propensity for aflatoxin contamination.

Evidence presented at the hearing suggests that aflatoxin contamination first occurs in the field and can continue to occur until pistachios are dried to a level where mold cannot grow. Industry research shows that most of the aflatoxin occurs in early split nuts or pistachios where the hull is damaged prior to harvest. A high percentage of small pistachios have a tendency to split early compared to larger pistachios. Accordingly, witnesses explained that there is a strong correlation between smaller, lighter pistachios with staining on the shell and the presence of aflatoxin.

Record evidence presented on the basis of research conducted by Mark A. Doster and Themis J. Michailides (''Characteristics of Pistachio Nuts with Aspergillus Molds,'' 1991) delineates a positive correlation between early split pistachios and aflatoxin. A witness citing this study quoted, ''Early splits (ES) are pistachio nuts that have both hull and shell split and frequently have moldy and/or insect-infested kernels. The hulls of ES nuts split over a several week period prior to harvest. Those ES that split earlier than two weeks before harvest had four times greater Aspergillus mold contamination compared with ES that split within two weeks of harvest. Both older ES and ES with moldy kernels had very different physical characteristics compared to normal nuts: fruits and kernels weighed less, hulls were more shriveled, and shells were smaller and stained * * *. In a typical orchard approximately 1 to 4% of the nuts are ES at harvest time. Molds in the genus Aspergillus are frequently found in ES nuts.''

According to other studies cited at the hearing, 90 percent of aflatoxin is contained in 4.6 percent of low-quality pistachios. Witnesses citing these studies further stated that removal of low-quality product, defined as smaller, lighter, stained-shell nuts typically found in ''early splits'', would reduce the average presence of aflatoxin in pistachios from 1.2 to 0.12 nano-grams/gram (ng/g) for all product sold for human consumption.

Furthermore, drawing from a study on the distribution of aflatoxin in processed and unprocessed pistachios, witnesses cited the study's conclusion that, ''all aflatoxin found here arises in the orchard; none is produced under normal processing conditions.''

Record evidence demonstrated that aflatoxin occurs rarely in a very small number of nuts, it originates in the field, and it is predominantly found in early split or damaged pistachios which have very different physical characteristics than higher quality pistachios.

Due to the exceptional physical characteristics of the infected nuts, witnesses explained that these nuts should be removed as part of the industry's handling procedures. As such, witnesses advocated the implementation of mandatory regulations that would not only set a maximum level of aflatoxin, but also, through quality and size specifications, encourage the removal of those nuts that both have the least consumer acceptance and are most likely to harbor aflatoxin.

Marketing Policy

Proposed § 983.37 would require that the committee prepare and submit to USDA prior to August 1st of each year an annual marketing policy. The marketing policy would serve as the basis for any committee recommendations for revisions in quality regulations for the upcoming crop year. Record evidence explained that in developing its marketing policy, the committee should consider production, harvesting, processing and storage conditions, as well as current and prospective prices.

Proposed Aflatoxin Provisions

According to testimony presented by Dr. Al Eaton, Director of the Center for Ecogenetics and Environmental Health, and the Department of Environmental Health, School of Public Health and Community Medicine, both of the University of Washington, aflatoxin is a known contaminant in pistachios. Dr. Eaton's testimony outlined the scientific arguments behind regulating aflatoxin as a known human carcinogen. Other witnesses argued that regulation of aflatoxin is an important factor contributing to the quality of pistachios. Witnesses testified that regulation of aflatoxin is crucial to positive acceptance of pistachios among consumers and growth of consumer demand.

As stated by Dr. Eaton, the U.S. and international scientific communities have reviewed the significance of aflatoxin in human food and animal feed extensively. Dr. Eaton referred to studies by Eaton and Groopman, 1994, as well as the Food and Agriculture Organization and World Health Organization's Joint Expert Committee on Food Additives (JECFA), 1998. Dr. Eaton stated that limiting aflatoxin in affected commodities is important in regard to these concerns.

Proposed § 983.38(a) would provide for a maximum aflatoxin level for pistachios shipped for domestic human consumption. The level supported by record evidence is 15 parts per billion (ppb). Under this provision, no pistachios with an aflatoxin level greater than 15 ppb could be shipped for domestic human consumption. Witnesses testifying at the hearing stated that the 15 ppb threshold is an appropriate level to ensure the quality of pistachios. Witnesses also explained that 15 ppb is the maximum level of aflatoxin allowed in peanuts, another commodity known to be affected by aflatoxin-bearing molds (7 CFR part 996).

The United States Food and Drug Administration (FDA) currently employs an aflatoxin tolerance level in pistachios of 20 ppb. Thus, this proposal would be more restrictive than what is currently accepted by the FDA. Witnesses explained that the 15 ppb was selected as the proposed maximum threshold to ensure that sampling procedures would result in aflatoxin tolerances below the current FDA level.

Proposed § 983.38(a) also provides that an aflatoxin inspection certificate must cover all shipments for domestic human consumption. Further, any pistachios that fail to meet the aflatoxin requirement must be disposed of in certain ways. The inspection and substandard pistachio disposition procedures are discussed in detail later in this document.

At the hearing, witnesses recommended eliminating the decimal point and the zero from all references to ''15.0'' ppb. The maximum aflatoxin threshold should read ''15'' ppb. Witnesses explained that current testing techniques available to the industry are only accurate to one part per billion. As such, requiring testing beyond the one part per billion would not be compatible with current industry testing abilities. Similarly, references to ''5.0'' ppb and ''10.0'' ppb should be changed to ''5'' ppb and ''10'' ppb in all corresponding descriptions of aflatoxin test sampling procedures. These changes are reflected in the proposed order language contained in this Recommended Decision.

Witnesses testified that a considerable amount of concern and debate over the proposed aflatoxin and other quality requirements resulted in the details of those proposed requirements being included in the proposed order language. According to the record, industry discussions favored including specific regulatory language in the order over establishing committee authority to recommend such regulations. Witnesses explained that the former would allow industry participants to know, prior to voting on the proposed order in referendum, what specific requirements would be imposed on the industry. Thus, producers would be able to make a more informed decision as to whether they favor the program.

Witnesses testified that the committee should have the authority to make recommendations to the Department to change the specified maximum aflatoxin level of 15 ppb. Paragraph (b) of proposed § 983.38 therefore provides authority for changing the allowable level of aflatoxin in the event that industry conditions change or research shows that a change in the aflatoxin level would be appropriate. As previously discussed under Material Issue 5(b), such a recommendation would require the concurring votes of at least seven committee members.

Transfer Between Handlers

Paragraph (c) of § 983.38 would provide that transfers of pistachios between handlers within the production area are exempt from the aflatoxin requirement.

Record evidence indicates that pistachios are customarily traded among handlers. Trade among handlers predominantly occurs as a means for individual handlers to buy or sell pistachios to meet the specific needs of their respective customers. Witnesses also explained that some handlers are better equipped than others to handle pistachios that present processing problems. As such, pistachios requiring re-working to meet industry quality standards are often transferred from one handler to another for more efficient handling.

An example of an inter-handler transfer presented at the hearing described a handler who is unable to ship pistachios because they have too much dark stain on the shells, and are deemed to be unmarketable in that state. However, another handler is able to paint the shells with a red food grade colorant that covers the dark stain, making the pistachios acceptable to consumers. Transferring the pistachios from the first handler to the second handler could benefit both parties.

Proposed § 983.38(c) would facilitate transfers of pistachios between handlers, which would allow for the highest use of the pistachios. While pistachios could be transferred from one handler to another without first being tested and certified as meeting the aflatoxin requirement, those pistachios would have to meet that requirement prior to entering the market for domestic human consumption. If the pistachios had been tested and certified as meeting the aflatoxin requirement by the first handler, those pistachios would not have to be tested and certified a second time. This would be true only if the lot's identity had been preserved, as discussed in the discussion below relative to ''Traceability.''

Traceability

Proposed § 983.38(d) would require that each lot of pistachios inspected for aflatoxin be uniquely identified and traceable from the point of testing through shipment by the handler. This is necessary because the handling of pistachios consists of a number of different steps that occur over a period of time.

Witnesses stated that identification of individual lots would be necessary in order to distinguish one lot from another for aflatoxin certification purposes. Unique identification and traceability of lots would be necessary to ensure handler compliance with the provisions of the order. Further, in the event that sub-quality or aflatoxin contamination was found by a handler or his or her customers, traceability would allow for expeditious response on the part of that handler to remove such product from the production line or market.

Traceability would be accomplished through the maintenance of each lot's identity as that lot proceeds through a handling facility. A lot could be in a handler's storage bins when a sample is taken for aflatoxin testing and certification purposes. The pistachios could be run through a roasting line later that day, and packaged on a subsequent day. In this example, witnesses explained that the handler would assign a unique number to the lot when the sample is taken, and the pistachios in the lot would be identified by that number through the entire handling process. This issue is further discussed in relation to proposed § 983.44, ''Inspection, certification and identification.''

Sampling

Proposed § 983.38(d)(1) and (d)(2) outline sampling procedures for testing for aflatoxin and other quality requirements. The samples would be drawn by an inspector or under the supervision of an inspector.

Witnesses explained that each sample drawn would need to be sufficient to meet testing procedure requirements under proposed §§ 983.38 (Aflatoxin levels) and 983.39 (Minimum quality levels). The record shows that having one sample drawn to serve both purposes would make the testing procedures more efficient and cost effective, as the process of drawing samples for each certification process would be condensed into one. Witnesses explained that this would help minimize inspection fees, as less sampling time would be needed. Sampling procedures for aflatoxin and minimum quality (including size) certification are described below, and under the discussion of proposed § 983.39.

Aflatoxin Sampling Procedures

As previously discussed, the record is that aflatoxin typically presents itself in high concentrations in very few nuts. Witnesses recommended a sampling system rooted in statistical calculations of aflatoxin per lot based on varying sample sizes calibrated to lot weight. The recommended sampling protocol would rely on established statistical sampling methodologies.

As there is not an internationally agreed upon procedure for aflatoxin sampling of pistachios, the proposed sampling regimen is based upon sequential sampling procedures used in the U.S. peanut industry; sampling parameters identified by experts in the field; and sampling protocols currently used by the European Union.

Record evidence stated that each lot sample for inshell and kernel pistachio aflatoxin testing must be made up of a prescribed number of incremental samples. Incremental sampling would be accomplished with an automatic sampling device or with a sampling probe.

Witnesses explained that automatic samplers are devices that extract random samples from a stream of pistachios while the nuts are processed in the handler's plant. Sampling probes are tubes, with 5 to 10 ports, that are pushed down into bins of bulk pistachios. The probe extracts pistachios from the bin at different levels of the bin ensuring that a cross sample of the pistachios in the bin are taken for testing and facilitates the collection of the required incremental samples. Probing devices are widely used in the sampling of other food products with similar physical characteristics.

According to record evidence, the number of incremental samples and the total weight of the lot sample would be dependent on the size of the lot. As shown in the table below, a small lot of inshell pistachios weighing 220 pounds or less would require 10 incremental samples, resulting in a total lot sample weighing 3 kilograms. For a larger lot of inshell pistachios weighing 22,001 pounds to 150,000 pounds, a lot sample of 30 kilograms would consist of 100 incremental samples. As discussed later, the total lot sample would then be divided into three test samples. The fourth column of the table shows the weight of each of the test samples.

INSHELL PISTACHIO LOT SAMPLING INCREMENTS FOR AFLATOXIN CERTIFICATION

Lot weight (lbs.)	Number of incremental samples for the lot sample	Total weight of lot sample (kilograms)	Weight of test sample (kilograms)
220 or less	10	3.0	1.0
221–440	15	4.5	1.5
441–1100	20	6.0	2.0
1101–2200	30	9.0	3.0
2201–4400	40	12.0	4.0
4401–11,000	60	18.0	6.0
11,001–22,000	80	24.0	8.0
22,001–150,000	100	30.0	10.0

For aflatoxin testing of pistachio kernels, the proposed incremental sampling requirements would follow the same methodology. The number of incremental samples would depend on the size of the lot, and would equal the number required for inshell lots of pistachios. However, the lot samples for kernel testing would be half the weight of the lot samples for inshell pistachio testing. This is because, as the record shows, half of the weight of inshell pistachios is made up of the shell, and only the kernels are tested for aflatoxin.

According to the below table, a lot sample for a lot of 220 pounds or less of kernels would equal 1.5 kilograms and consist of 10 incremental samples. A lot sample for a lot of 22,001 pounds to 150,000 pounds of kernels would equal 15 kilograms and would consist of 100 incremental samples.

PISTACHIO KERNEL LOT SAMPLING INCREMENTS FOR AFLATOXIN CERTIFICATION

Lot weight (lbs.)	Number of incremental samples for the lot sample	Total weight of lot sample (kilograms)	Weight of test sample (kilograms)
220 or less	10	1.5	.5
220–440	15	2.3	.75
441–1100	20	3.0	1.0
1101–2200	30	4.5	1.5
2201–4400	40	6.0	2.0
4401–11,000	60	9.0	3.0
11,001–22,000	80	12.0	4.0
22,001–150,000	100	15.0	5.0

The above tables provide for lot sizes up to 150,000 pounds. The record shows that this reflects current industry practice. That is, handlers do not handle lots in excess of that amount. However, in the event that these practices change, proposed section 983.46 would allow the proposed sampling methodology to accommodate the change. Any change in sampling procedures would require a recommendation of the committee and approval of the Department. Proposed § 983.46 is discussed further under ''Modification or suspension of regulations.''

The record evidence is that the next step in the sampling process should be that the lot samples for inshell and kernel aflatoxin testing be divided into 3 equal test samples. The dividing of the lot sample would be conducted by, or under the supervision of, an inspector with the Federal or Federal-State Inspection Service (Inspection Service). Witnesses testified that any inspection process in use by the Inspection Service should be available to pistachio handlers under the proposed order. Inspection programs that could be used include the ''Partners In Quality'' program and the ''Customer Assisted Inspection Program.''

Aflatoxin Testing Procedures

As provided in § 983.38(d)(2), lot samples intended for aflatoxin testing and certification would be submitted to a laboratory that has been approved or accredited for aflatoxin analysis by the USDA. Witnesses explained that such a laboratory could be a third-party laboratory or a laboratory run by an individual handler. In any case, witnesses stated that any laboratory conducting aflatoxin testing for certification under the provisions of the proposed order would be required to be approved or accredited by the USDA.

The test samples would be processed according to the provisions proposed under § 983.38(d)(3). The laboratory would record the receipt of each test sample. The test samples would then be prepared and chemically analyzed according to established testing procedures prescribed under the High Pressure Liquid Chromatograph (HPLC) or Vicam (Aflatest) aflatoxin testing methodologies, or any other method recommended by at least seven members of the committee and approved by USDA.

The language authorizing the use of additional testing methods represents a departure from the language contained in the Notice of Hearing. The revised language was proposed by proponents of the marketing order and would provide the committee with additional flexibility in identifying acceptable methods of testing. The authority to review and recommend alternative methods of aflatoxin testing for approval by the Department would allow for the accommodation of advances in aflatoxin technology.

Proposed § 983.38(d)(4) sets forth the process by which the test samples would be analyzed in order to determine whether a lot met the maximum aflatoxin threshold of 15 ppb.

As previously mentioned, each lot sample would be divided into three test samples. If the first sample tested, test sample 1, had an aflatoxin level at or below 5 ppb, the lot would be certified as negative to aflatoxin. No analysis of the other two test samples would be necessary. If test sample 1 were to test at or above 25 ppb, the lot would fail and the accredited laboratory would fill out a failed lot notification report as specified in § 938.40, described below.

If test sample 1 were to test above 5 ppb and below 25 ppb, the handler could either elect to continue the testing process or voluntarily re-work the lot. If the lot is re-worked, it would be subject to sampling and testing as if it were a new lot altogether.

If the handler elects not to re-work the lot and go forward with the testing, the accredited laboratory would analyze test sample 2, and the results of test samples 1 and 2 would be averaged. The lot would be certified as negative to aflatoxin if the laboratory determines that the averaged result for test samples 1 and 2 is at or below 10 ppb. If the averaged result of test samples 1 and 2 is at or above 20 ppb, the lot would fail and the laboratory would fill out a failed lot notification report. If the averaged aflatoxin level of test samples 1 and 2 is above 10 ppb and below 20 ppb, the handler could withdraw the lot from testing and re-work it. Thereafter, the handler could resubmit the lot for sampling and testing under proposed § 983.38(d).

If the handler elected to continue with the testing, the laboratory would analyze test sample 3, and the results of test samples 1, 2 and 3 would be averaged. A lot would be certified as negative to aflatoxin and the laboratory would issue an aflatoxin inspection certificate if the averaged result of test samples 1, 2 and 3 is at or below 15 ppb. If the averaged aflatoxin level of test samples 1, 2 and 3 is above 15 ppb, the lot would fail and the laboratory would fill out a failed lot form as required by proposed § 983.40, ''Failed lots/re-work procedures.''

If a lot failed to test below the maximum threshold for aflatoxin, the laboratory would send a copy of the Failed Lots/Re-Work Procedure form to the committee and to the failed lot's owner within 10 working days of failure.

If an aflatoxin inspection certificate were issued certifying that a lot is negative to aflatoxin at any stage of the sequential testing, meaning the lot's aflatoxin content is below the maximum threshold, the certification would identify the lot by weight, grade and date. The certification would expire after 12 months.

The recommendation at the hearing that a handler may withdraw his or her lot from testing at any stage in the testing and certification process represents a change to the proposed order language contained in the Notice of Hearing. Witnesses recommended this modification so that if a handler was not satisfied with an early aflatoxin content result, he or she could elect to rework the lot before the expense of completing the testing protocol.

Proposed § 983.38(d)(5) provides that accredited laboratories perform aflatoxin tests. Each lot shipped for domestic human consumption would be required to be tested and certified by a laboratory that it meets the aflatoxin requirement. The records of each test and of the final shipping disposition would be required to be kept by the handler. The records would be required to be maintained for 3 years and would be subject to audit by the Department or the committee at any time. The maintenance of the records and the audit provisions are to enable the committee to determine handler compliance with the aflatoxin level requirements, and are discussed further under Material Issue 5(e).

Pistachios that fail to meet the aflatoxin requirement would be required to be reworked or disposed of. Witnesses stated that a rework option is important as the cultivation of pistachios requires a substantial investment, and maximizing saleable usage of each harvest is crucial to the economic well being of both producers and handlers. Equally important are disposal requirements for pistachios failing to be certified as negative to aflatoxin. Disposal procedures would be important in assuring industry and consumers that failed product does not enter the stream of domestic commerce. Requirements for disposal of failed lots are discussed later under proposed §§ 983.40, ''Failed lots/rework procedures'' and 983.45 ''Substandard pistachios.''

Proposed § 983.38(d)(6) provides that if test samples 2 or 3 are not used for testing and certification purposes, the handler could request the laboratory to return those samples to him or her. This would allow handlers to sell the pistachios that comprise test samples 2 and 3 for domestic human consumption if the lot is shown to comply with the aflatoxin regulation with the testing of sample 1. For example, with larger lots of 22,001 to 150,000 pounds, this would allow the handler to sell an additional 44 pounds of pistachios for human consumption.

Proposed Minimum Quality Levels

The record supports minimum quality requirements for pistachios being included in the proposed order. These requirements, set forth in proposed § 983.39, would establish maximum tolerances for certain internal and external defects, and a minimum size specification.

The record shows that elimination of shell defects, bad tasting, insect-infested and closed pistachios would not only increase consumer satisfaction but also reduce the incidence of aflatoxin. Moreover, witnesses stated that, based on industry experience, most consumers prefer large pistachios. Because many consumers do not find smaller pistachios desirable, these pistachios sell for lower prices. Quality and size specifications would help improve grower returns by ensuring that California pistachios sold in the domestic market are of the quality that consumers prefer. Enhancing consumer demand by assuring acceptable quality (including the absence of aflatoxin) is necessary for the industry to market increasing supplies of California pistachios.

The record shows that the defects listed in proposed § 983.39 are generally accepted by the industry as those that reduce the marketability and consumer acceptance of pistachios. Handlers currently eliminate defective nuts in their normal operations to pack a product that meets their customers' expectations.

Four categories of defects are proposed. The first is external shell defects, which includes non-splits (shells that are not open), adhering hull material, dark stain, and other damage that materially detracts from the appearance of the shell. Next are internal defects, which include immature kernels, kernel spotting, insect damage, mold, rancidity, and decay. The third class of ''other defects'' includes shell pieces and blanks, foreign material, particles and dust, and loose kernels. The final category is in shell pistachios that are below the specified minimum size.

The proposed minimum quality requirements provide a maximum tolerance level for each type of defect. This is to recognize that in normal handling operations, it is impossible to eliminate every single defective nut from a lot. As an example, up to 5 percent (by weight) of the inshell pistachios in a lot may be below the minimum permissible size. The following table contains the proposed defects and tolerances.

MAXIMUM DEFECT AND MINIMUM SIZE LEVELS

Factor	Maximum permissible defects (percent by weight)	
	Inshell	Kernels
EXTERNAL (SHELL) DEFECTS		
a. Non-splits & not split on suture	10.0	
(1) Maximum non-splits allowed	4.0	
b. Adhering hull material	2.0	
c. Dark stain	3.0	
d. Damage by other means, other than a, b and c above, which materially detracts from the appearance or the edible or marketing quality of the individual shell or the lot	10.0	
INTERNAL (KERNEL) DEFECTS		
a. Damage: Immature kernel (Fills <75% − >50% of the shell), Kernel spotting (Affects ⅛ aggregate surface)	6.0	3.0
b. Serious damage—Minor insect or vertebrate injury/insect damage, insect evidence, mold, rancidity, decay	4.0	2.5
(1) Maximum insect damage allowed	2.0	0.5
Total external or internal defects allowed	9.0	
OTHER DEFECTS		
a. Shell pieces and blanks (Fills <50% of the shell)	2.0	
(1) Maximum blanks allowed	1.0	
b. Foreign material—No glass, metal or live insects permitted	0.25	0.1
3. Particles and dust	0.25	
4. Loose kernels	6.0	
	Minimum permissible defects (percent by weight)	
Maximum allowable inshell pistachios that will pass through a 30/64ths inch round hole screen	5.0	

Witnesses testified that about 90 percent of the pistachios produced in California are packed to higher quality standards than those being proposed in the order. Thus, imposition of these quality requirements should have a minimal impact on handlers, while ensuring that the pistachios available to U.S. consumers are of acceptable quality.

The terms used in the above table are defined in further detail under § 983.39(b) of the proposed order. These terms would clarify permissible maximum defects for inshell pistachios and pistachio kernels.

One of the terms defined in paragraph (b) of proposed § 983.39 is ''dark stain,'' an external defect. The definition of that term included in this Recommended Decision differs from that in the Notice of Hearing. In the Notice, dark stain was defined to mean an aggregate amount of discoloration affecting more than one-eighth of the shell surface or, on dyed nuts, when readily noticeable. Testimony at the hearing indicated that the last portion of that definition would have adversely impacted handlers who dye or color their nuts to remove cosmetic shell defects. Thus, this provision has been modified to exempt dyed or colored nuts from the dark stain requirements. This exemption is intended to allow handlers to improve the marketability of pistachios containing dark stain by covering that defect with a dye or color coat.

Witnesses stated that each shipment of California pistachios intended for domestic human consumption would require a minimum quality certificate. As previously discussed, this certificate would be issued by an inspector and would certify that the pistachios contained in that lot meet the established minimum quality requirements. Pistachios that fail to meet the minimum quality specifications would be disposed of in such manner as described in proposed § 983.40.

The record also states that under proposed § 983.39 (d), transfers between handlers within the production area would be exempt from minimum quality and size regulation. This exemption, as with a similar exemption for aflatoxin certificates, is designed to allow transfer of product between handlers. It would allow handlers to sell and trade pistachios of varying qualities among themselves, and would allow for efficiencies within the industry due to different handlers' abilities to prepare pistachios for market. All pistachios would have to be inspected and certified as meeting minimum quality requirements before being shipped for domestic human consumption.

As with aflatoxin testing, provisions for minimum quality and size testing under the order would require that lot samples consisting of a minimum number of incremental samples be drawn. A minimum number of incremental samples would be required to protect the statistical validity of the testing process and to ensure that the test sample is representative of the quality of the entire lot of pistachios from which it was drawn.

As shown in the table below, the number of incremental samples per lot sample would be the same under the aflatoxin testing as under the minimum quality and size testing requirements. This would allow the handler to pull one set of samples for both tests, as previously explained. The sample would be drawn by, or under the supervision of, an inspector.

INSHELL AND KERNEL PISTACHIO LOT SAMPLING INCREMENTS FOR MINIMUM QUALITY CERTIFICATION

Lot weight (lbs.)	Number of incremental samples for the lot sample	Total weight of lot sample (grams)	Weight of inshell and kernel test sample (grams)
220 or less	10	500	500
221–440	15	500	500
441–1100	20	600	500
1101–2200	30	900	500
2201–4400	40	1200	500
4401–11,000	60	1800	500
11,001–22,000	80	2400	1000
22,001–150,000	100	3000	1000

According to witness testimony, a lot of inshell pistachios weighing 220 pounds or less would require a lot sample weighing a total of 500 grams. This lot sample would consist of 10 incremental samples collected throughout the lot. Alternatively, a lot weighing 22,001 pounds to 150,000 pounds would require a lot sample equal to 3,000 grams and would consist of 100 incremental samples.

A test sample would then be taken from the lot sample. For lots up to 11,000 pounds, the test sample would equal 500 grams. For any lot in excess of 11,000 pounds, the test sample would be 1,000 grams.

The test sample sizes for minimum quality requirements differ from those for aflatoxin testing. Under the aflatoxin testing system, the lot sample drawn would be divided into three equal test samples, with each sample being used progressively depending on the aflatoxin content of each test sample. Under the sampling and testing procedures for the proposed minimum quality requirements, the test sample would be used in its entirety. Inspectors would assess the quality of the test sample for external and internal defects.

Table 4 in proposed § 983.39(e)(1) has been revised from that included in the Notice of Hearing. An additional column entitled ''Weight of kernel test sample (grams)'' has been eliminated, and the column previously entitled ''Weight of inshell test sample (grams)'' has been re-titled to ''Weight of inshell and kernel test sample (grams).'' These changes are based on witness testimony that the test sample sizes for inshell and kernel testing should be the same.

Proposed Minimum Quality Testing Procedures

Witnesses stated that the test samples should be analyzed in accordance with USDA inspection procedures. This would ensure that the pistachios do not contain in excess of the maximum permissible defects and that they meet the minimum size level.

Under the USDA inspection procedures, the inspector would analyze the test sample for external, internal, and other defects. The nuts would be shelled for further analysis of internal kernel defects if the pistachios exhibited dark stain, adhering hull, or other external defects, or if, in the inspector's opinion, they had possible internal defects.

Witnesses explained the importance of this requirement as studies have shown that nuts with external defects have a higher probability of kernel defects. These studies, discussed earlier in this document, linked certain quality defects with the incidence of aflatoxin. Nuts with unblemished shells would be subject to internal kernel analysis at the discretion of the inspector. After testing, inspectors would certify that the lot had met the minimum quality levels.

The record states that handlers would be required to keep testing and certification records, along with records of final shipping disposition, for three years after the crop year in which the pistachios were shipped. These records would be subject to audit by the committee at any time. These requirements would be important in allowing the committee and the USDA to ensure that pistachio handlers comply with the proposed provisions of the order. As stated in the discussion of proposed aflatoxin testing procedures, each lot tested for minimum quality and size certification would also be required to be uniquely identified to ensure traceability.

Substandard Pistachios

Proposed § 983.40 addresses procedures recommended by the witnesses for reworking or disposing of substandard pistachios. Substandard pistachios are pistachios that fail to test below the maximum aflatoxin tolerance level or do not meet minimum quality (including size) requirements.

According to record testimony, handlers would have different options available for managing substandard pistachios. The first of these would allow a handler to rework a lot of pistachios until that lot met the aflatoxin and quality requirements proposed under the order. If, after being reworked, the pistachios met the aflatoxin and minimum quality levels, those pistachios could be shipped for domestic human consumption.

If a handler chose not to rework a lot of substandard pistachios, then the handler would be required to either dispose of those nuts or use them for non-human consumption. These pistachios could also be exported if they met the requirements of the receiving country.

Proposed § 983.45 would prevent substandard pistachios from entering the stream of domestic human consumption. Under the provisions of this section, reporting and disposition procedures for substandard pistachios would be implemented by USDA (upon recommendation of the committee) through informal rulemaking.

Failed Lot Reporting

According to record evidence, § 983.40(b) would establish reporting requirements for lots failing to meet aflatoxin or minimum quality requirements of the proposed order. Reports of failing lots would have to be filed with the committee within 10 working days of the test failure. Reports regarding lots exceeding the maximum aflatoxin tolerance level would be sent by the accredited laboratory directly to the committee. Reporting of lots exceeding the maximum aflatoxin requirements directly by the laboratory rather than the handler would expedite and increase the efficiency of the committee's ability to locally oversee industry compliance to the proposed aflatoxin provisions. Reports concerning lots failing to meet the minimum quality requirements would be filed by the handler with the committee, as minimum quality testing would be conducted at the handler's facility and not at a laboratory.

Establishing reporting procedures for lots failing to meet the requirements of the order would assist the committee in ensuring that only certified lots are used for domestic human consumption. This would help ensure that poor quality pistachios are either re-worked to requisite quality and aflatoxin levels, or properly disposed of. In this context, witnesses stated that failed lots reporting would be essential to supporting the committee's oversight and auditing responsibilities. Failed lot reporting would also present the committee with an important information-gathering tool, as it would allow the compilation of industry quality statistics.

Rework Procedures

Notification of a failed lot, either with regard to aflatoxin or quality, would alert the committee to the possible reworking of pistachios for reinspection, or to the disposal of those pistachios. Witnesses expressed the importance of establishing rework procedures in order to allow handlers the opportunity to separate acceptable quality pistachios from inferior ones. Witnesses explained that while reworking and reinspection would not be required under the order, rework would provide handlers with an opportunity to secure a better return for their pistachios. Rework and reinspection procedures should therefore benefit both handlers and producers.

Witnesses expanded on the importance of safeguarding against the negative effect of poor quality pistachios in the marketplace by explaining that lots failing to meet aflatoxin requirements would be subject to a different set of rework procedures than those failing quality requirements.

Rework procedures for inshell pistachios failing to meet aflatoxin requirements would require handlers to remove 100 percent of the failing lot from its bulk or retail packaging. These pistachios would be required to pass through the sorting stages of the handling process in order to remove from the lot those nuts having the characteristics most susceptible to harboring aflatoxin. Witnesses stated that after reworking the lot, the weight of the total accepted and rejected product would be reported to the committee. The acceptable portion of the reworked lot would again be sampled and tested for aflatoxin, as proposed under § 983.38, Aflatoxin levels, with one exception. In the case of a reworked lot, the lot sample size and the test sample size would be doubled from that specified in Table 1 of proposed § 983.38. In addition to being tested for aflatoxin content, the reworked lot would also be sampled and tested for minimum quality.

If, after having been reworked, the lot fails aflatoxin testing for a second time, the lot could be shelled and the kernels reworked, sampled and tested in the manner required for an original lot of pistachio kernels. If the handler decided not to pursue further reworking of the failed lot, those pistachios would be prohibited from entering the stream of commerce for domestic human consumption. That lot would be required to be disposed of, sold for domestic non-human consumption purposes, or exported in compliance with the receiving country's requirements.

Rework procedures proposed for pistachio kernels failing to test negative to aflatoxin would also require a re-processing of 100 percent of the volume of the failing lot. After reworking, witnesses stated that the total weight of the accepted product and the total weight of the rejected product would be reported to the committee for verification purposes. The reworked lot of kernels would be sampled and reinspected for aflatoxin as specified in the aflatoxin requirements of the order.

According to record evidence, handlers should also be able to rework lots that fail to meet the minimum quality requirements proposed in § 983.39 of the order. As in the case of pistachios failing aflatoxin requirements, handlers would need to remove from packaging and rework 100 percent of the product within that lot. Reworking would be completed by standard sorting techniques, including mechanical, electronic or manual procedures normally used in the handling of pistachios.

The reworked lot would be sampled and tested as required under proposed § 983.39, ''Minimum quality levels.'' There would be no limit to the number of times a lot could be reworked for minimum quality levels.

Testing of Minimal Quantities

The record supports simplified aflatoxin testing requirements for handlers who handle less than one million pounds of assessed weight of pistachios a year. Additionally, such handlers should qualify for an exemption from minimum quality inspection and certification requirements under certain circumstances. Including these provisions in the proposed order would reduce costs for the smallest handlers, while maintaining the industry objective of having all pistachios used for domestic human consumption meet certain quality (including aflatoxin) levels.

Section 983.41 of the proposed order, Testing of minimal quantities, would provide that aflatoxin testing for handlers of minimal quantities (less than a million pounds per year) could be accomplished in two ways. The first option would allow a handler to have an inspector sample and test all the handler's hulled and dried pistachios for aflatoxin certification prior to further processing. If the pistachios meet the proposed aflatoxin requirement, an aflatoxin certificate would be issued to cover the handler's total inventory. The handler would not then have to comply with the traceability procedures set forth in paragraph (d) of proposed § 983.38.

If the pistachios did not meet the aflatoxin requirements, the handler could subdivide his or her inventory into smaller lots and have each individual lot sampled and tested for aflatoxin. Any lots found to be above the maximum aflatoxin threshold could be reworked and would then be subject to the testing procedures specified in § 983.38.

Witnesses testifying at the hearing stated that small handlers should be allowed to test all of their hulled and dried pistachios before the pistachios are further processed for quality and size. The language of proposed § 983.41(a) has been so clarified.

Witnesses also testified that handlers of minimal quantities could apply to the committee for an exemption from inspection with respect to the minimum quality requirements set forth in proposed § 983.39 of the order. If the exemption were granted, the handler would be required to pull and retain (for 90 days) samples from each lot shipped. The samples would be required to be made available for review by the committee.

Witnesses explained that if it was determined that an exempt handler were shipping substandard pistachios, the committee should be able to revoke the handler's exemption. The handler in question would then be subject to minimum quality and size inspections until further determination by the committee. The record indicates that implementing regulations should be effectuated to establish the specific procedures for such exemptions.

Commingling

Witnesses recommended under proposed § 983.42 that after a lot were issued an aflatoxin inspection certificate and minimum quality certificate, it could be commingled with other certified lots and maintain its aflatoxin and minimum quality certifications. However, handlers would be required to comply with paragraph (d) of proposed § 983.38 which provides that each certified lot be identified and traceable from testing through shipment. Thus, if pistachios were transferred between handlers prior to certification, those pistachios would be required to meet the certification provisions of this proposed order prior to being commingled with other certified lots. In the case of the exemption from minimum quality certification for handlers handling less than 1 million pounds, any pistachios transferred from an exempt handler to a non-exempt handler would be subject to minimum quality certification.

Reinspection

Witnesses supported authority for the committee to reject an inspection certificate and request reinspection of a lot whenever it has reason to believe that pistachios may have been damaged or deteriorated while in storage. That lot would be prevented from entering the marketplace for domestic human consumption until a new certification was obtained.

USDA would not allow invalidation of a certificate that has been issued by an inspector. However, there may be circumstances that warrant a requirement that a lot be subject to a second inspection. Thus, proposed § 983.43, Reinspection, is modified to provide that the Department, upon recommendation of the committee, may establish rules and regulations to establish conditions under which pistachios would be subject to reinspection.

Inspection, Certification and Identification

The record indicates that all pistachios shipped for domestic human consumption should be required to be inspected and certified as meeting the order's quality requirements (including those pertaining to aflatoxin levels). If deemed necessary, lots of pistachios could be required to be identified by appropriate seals, stamps, tags, or other identification affixed to the containers by the handler. All inspections would be at the expense of the handler.

Witnesses testified that not all handlers would have their pistachios tested or inspected at the same point in the handling process. The proposed order is intended to be flexible, as it was explained by witnesses that inspection could be appropriate for certain handlers at one stage in the process while being appropriate for other handlers at another stage. Witnesses stated that differences in inspection timing throughout different handlers' processing systems would not pose a compliance problem as long as lot identity was required and maintained.

Several handler witnesses testified that they have already implemented traceability systems in their plants. Currently, several different systems for tracking lots of pistachios exist in the industry. Record testimony indicates that some handlers identify lots by date and shift. These lots are then traced by written records maintained by the handler's staff. Other handlers mark the containers with a code using crayons or markers. Yet other handlers use bar codes.

The record indicates that current handling practices relating to the tracking of lots may be adequate for compliance purposes under the order. However, if deemed necessary, the USDA, upon recommendation of the committee, could issue rules to specify that handlers be required to affix some standardized type of identification to the containers in a lot.

The record shows that the responsibility for affixing such identification could be given to the handlers without requiring it be done under the direction or supervision of an inspector. This represents a departure from the regulatory text of proposed § 983.44 contained in the Notice of Hearing. Originally, affixing of identification would have been required under the supervision of an inspector. Witnesses explained that giving handlers the responsibility to maintain pistachio identity could result in more flexibility in handlers' operations and lower costs. Section 983.44 has been modified accordingly.

Substandard Pistachios

Record evidence indicates that the committee should have the authority to establish reporting and disposition requirements as it deems necessary to ensure that pistachios which do not meet the aflatoxin and minimum quality requirements prescribed by § 983.38 and § .39 are not shipped for domestic human consumption. This authority would appear in § 983.45 of the proposed order, and would require approval by the Department through the informal rulemaking process.

Witnesses opined that much of the information the committee and the Department would need to administer the order has been covered by reporting requirements set forth elsewhere in the proposed order. For example, reports would be required when pistachio lots fail testing for the aflatoxin tolerance or fail inspections for minimum quality and size specifications. However, in the course of administering the order, the committee may determine that further reports are necessary. This section gives the committee the authority to establish further reporting requirements, subject to the approval of the Department.

The committee should also be authorized to recommend other rules (aside from those relating to reporting requirements) needed to ensure appropriate disposition of substandard pistachios. For example, handlers could be required to dispose of substandard pistachios under the supervision of the committee staff or an inspector. Again, such rules would need to be approved by USDA.

In the Notice of Hearing, reference to § 983.38 was inadvertently omitted from § 983.45 of the proposed order. This oversight is corrected in this document.

Modification or Suspension of Regulations

According to record evidence, proposed § 983.46 should allow for modification, suspension, or termination of the requirements in §§ 983.38 through 983.45 of the order. These sections of the proposed order relate to aflatoxin and minimum quality requirements.

The record shows that the quality and aflatoxin requirements specified in the proposed order are reasonable and appropriate at the current time. However, if the committee were to determine by reasons of changed industry conditions (such as development of new technology) that certain provisions of the order need to be modified, suspended or terminated, the committee should have the authority to make those recommendations. All such recommendations would require seven concurring votes by the committee and would be subject to review and approval of USDA through the rulemaking process.

Additionally, the record shows that the committee should have the authority to recommend any rules necessary for the implementation of the provisions of §§ 983.38 through 983.45 of the proposed order. Again, any such recommendation would require USDA approval. It is recommended that a new paragraph (c) be added to proposed § 983.46 to add this authority to the order.

Material Issue Number 5(e)—Reporting and Recordkeeping

The record evidence is that the committee should have the authority, with the approval of the Department, to require handlers to submit such reports and information as the committee may need to perform its functions and fulfill its responsibilities under the order. The committee would need to collect information for such purposes as collecting assessments, compiling statistical data for use in market evaluation, and determining whether handlers are complying with order requirements. The types of information that could be collected to fill these reporting needs include but are not limited to production, sales and inventory data, and information pertaining to transfers of pistachios between handlers.

Additionally, under proposed § 983.49, each handler would be required to maintain records with respect to pistachios acquired, processed, further handled, sold, or otherwise disposed of, as would be necessary to verify the reports that the handler submits to the committee. All such records would be required to be maintained for at least 3 years after the end of the fiscal year in which the transaction occurred.

Witnesses also stated that the order should provide the authority for USDA and authorized employees of the committee to examine those records pertaining to matters within the purview of the order. This provision would enable verification of compliance with requirements of the proposed order.

All reports and records submitted to the committee by handlers would be required to remain confidential and be disclosed only as authorized by USDA in accordance with the Act. However, the committee would be authorized to release composite information from any or all reports. Such composite information could not disclose the identity of the persons furnishing the information or any person's individual operation.

The record shows that industry handlers already collect and maintain much of the information contemplated to be reported and retained under the proposed order provisions. Thus, compliance with the provisions of the order with regard to reporting and recordkeeping would entail minimal handler costs.

Material Issue Number 5(f)—Compliance

No handler should be permitted to handle pistachios except in conformity with the provisions of the order, as set forth in proposed § 983.58. If the program is to be effective, compliance with its requirements is essential.

Material Issue Number 5(g)—Continuance Referenda

In accordance with proposed § 983.67(d), the order should provide that the Department conduct periodic continuance referenda every 6 years. The initial continuance referendum should be conducted within 6 years of the effective date of the marketing order.

USDA has determined that continuance referenda are an effective means for ascertaining whether producers favor continuance of marketing order programs. As such, the proposed marketed order should include a provision for continuance referenda.

The Act provides that in the promulgation of a marketing order, at least two-thirds of the producers voting, by number or by volume represented in the referendum, must favor the issuance if the order. Continuance referenda should be based on the same standard of industry support. This requirement is considered adequate to measure producers' support to continue the marketing order.

The Department would consider termination of the order if less than two-thirds of the producers voting in the referendum and producers of less than two-thirds of the volume of pistachios represented in the referendum favor continuance. In evaluating the merits of continuance versus termination, USDA would not only consider the results of the referendum. The Department would also consider all other relevant information concerning the operation of the order and its relative benefits and disadvantages in order to determine whether continued operation of the order would tend to effectuate the declared policy of the Act.

The Department's ''Guidelines for Fruit, Vegetable and Specialty Crop Marketing Orders'' provide for periodic referenda to allow producers the opportunity to indicate their support for or rejection of a marketing order. It is the position of the Department that periodic referenda ensure that marketing order programs continue to be accountable to producers, obligate producers to evaluate their programs periodically, and involve them more closely in their operation. The record evidence supports these goals.

In any event, section 608(C)(16)(B) of the Act requires the Department to terminate the order whenever the Department finds that the majority of all producers favor termination, and that such majority produced more than 50 percent of the commodity for market.

Material Issue Number 5(h)—Exemption for Small Quantities

Proposed § 983.69, ''Exemption,'' states that any handler who handles 1,000 dried pounds of pistachios or less during any year may handle pistachios free of the regulatory and assessment provisions of the proposed order.

The record shows that the purpose of this provision is to provide an exemption from the proposed requirements of the order for small quantities of pistachios, such as those that are grown for home or personal use. This section may be changed, as recommended by the committee and approved by the Department. For example, the committee may recommend that the 1,000-pound threshold be revised.

Additionally, implementing rules and regulations may be deemed necessary to ensure that handlers claiming this minimum exemption are not selling pistachios in domestic human consumption outlets that are not in compliance with the minimum quality requirements of the order. Such rules and regulations could be implemented under the authority in proposed § 983.45 of the order.

Material Issue Number 5(i)—California Pistachio Commission

Proposed § 983.70, ''Relationship with the California Pistachio Commission,'' is supported by witness testimony that the committee have authority to deliberate, consult, cooperate and exchange information with the California Pistachio Commission (CPC). Any sharing of information between the two organizations would be kept confidential in accordance with the provisions of section 10(i) of the Act.

Testimony offered by the Chief Executive Officer of the CPC further clarifies the potential efficiencies to be gained through cooperation of the CPC and the committee. As stated by the witness, the industry is already familiar with the structure and protocols of the Commission. Joint management of the two programs could reduce added paperwork, costs and duplication of efforts.

In terms of proposed regulation, witnesses stated that the two programs would be complimentary, as the provisions of each program would not overlap. The proposed provisions of the Federal program pertain to mandatory testing and certification for aflatoxin, quality and size. The CPC does not administer such regulation but rather focuses on promotion and research activities. The CPC does oversee the California Pistachio Marketing Agreement, but this is a voluntary agreement among handlers, and the quality parameters under the agreement do not include those addressed in the proposed order.

Witnesses speaking in support of § 983.71 explained that, when the Agreement was formulated, it was the intention of the participants to pattern the administrative and organizational structure of the Agreement after the Commission for the purpose of minimizing administrative costs and avoiding the duplication of efforts as much as possible. According to record testimony, this goal has been obtained and has allowed the Agreement signatories the ability to maintain a very low administrative overhead with a minimum of added paperwork. Witnesses stated that, if the Federal program is approved, it is their intention to capture similar benefits.

Material Issue Number 5(j)—Common Terms

The provisions of proposed §§ 983.59 through 983.69 and §§ 983.90 through 983.92 are common to marketing agreements and orders now operating. All such provisions are necessary to effectuate the other provisions of the marketing order and marketing agreement and to effectuate the declared policy of the Act. The record evidence supports inclusion of each provision. These provisions, which are applicable to both the marketing agreement and the marketing order, are identified by section number and heading as follows: § 983.59 Rights of the Secretary; § 983.60 Personal Liability; § 983.61 Separability; § 983.62 Derogation; § 983.63 Duration of immunities; § 983.64 Agents; § 983.65 Effective time; § 983.66 Suspension or termination; § 983.67 Termination; § 983.68 Procedure upon termination; and § 983.69 Effect of termination or amendment. Those provisions applicable to the marketing agreement only are: § 983.90 Counterparts; § 983.91 Additional parties; and, § 983.92 Order with marketing agreement.

Material Issue Number 6—Implementation of Proposed Order

Based on a review of the hearing record, USDA recommends that if California pistachio producers were to vote in favor of promulgating the proposed marketing order, the provisions of this program be implemented in two phases. This recommendation addresses the need to establish administrative procedures, guidelines and forms, some of which would require USDA rulemaking and OMB approval, for the mandatory inspection and certification provisions of the proposed program to function effectively.

The first phase would allow for the nomination and seating of an initial administrative committee, and the recommendation and implementation of administrative rules, including reporting and recordkeeping requirements, under which the program would operate. These activities include, but are not limited to, nominations of producer and handler members and alternate members of the committee, the selection of that committee by the Department, and holding committee meetings to select a staff, draft operating procedures, recommend a budget and assessment rate for the first fiscal period under the proposed order, and make other recommendations necessary to implement order authorities. Some of the committee recommendations would require rulemaking by the Department and approval of new information collection requirements by the Office of Management and Budget (OMB).

The second phase would allow for the implementation of the regulatory provisions proposed under this program and necessary procedures to effectively administer them. This would include the mandatory testing and certification provisions for maximum aflatoxin and minimum quality levels of California pistachios, and failed lot rework provisions under §§ 983.38 through 983.46 of the proposed order. USDA recommends that these provisions become effective on August 1, 2004.

This recommendation reflects the fact that, if the order were to be approved through a producer referendum and implemented in its entirety, the immediate effectiveness of regulatory provisions without adequate administrative procedures to support them could obstruct the flow of California pistachios to the marketplace. USDA believes that while the intended effect of the proposed order is to ensure the delivery of high quality California pistachios to consumers, implementation of the regulatory provisions proposed herein without adequate implementation of industry administrative procedures could result in the unintended disruption of California pistachio shipments.

Small Business Consideration

Pursuant to the requirements set forth in the Regulatory Flexibility Act (RFA), the Agricultural Marketing Service (AMS) has considered the economic impact of this action on small entities. Accordingly, the AMS has prepared this initial regulatory flexibility analysis.

The purpose of the RFA is to fit regulatory actions to the scale of business subject to such actions so that small businesses will not be unduly or disproportionately burdened. Small agricultural producers have been defined by the Small Business Administration (SBA) (13 CFR 121.601) as those having annual receipts of less than $750,000. Small agricultural service firms, which include handlers that would be regulated under the proposed pistachio order, are defined as those with annual receipts of less than $5,000,000.

Interested persons were invited to present evidence at the hearing on the probable regulatory and informational impact of the proposed pistachio marketing order program on small businesses. The record evidence is that while the program would impose some costs on the regulated parties, those costs would be outweighed by the benefits expected to accrue to the U. S. pistachio industry.

The record indicates that there are approximately 647 pistachio producers, which includes the members of the one existing pistachio producer cooperative. There are about 19 handlers who process pistachios in the production area proposed to be regulated.

Statistics prepared by the California Pistachio Commission and submitted as evidence at the hearing show that 445 California pistachio producers (69% of the total) produce less than 100,000 pounds per year; 100 producers (15%) produce more than 100,000 and less than 250,000 pounds; 43 producers (7%) produce more than 250,000 and less than 500,000 pounds; and 59 producers (9%) grow more than 500,000 pounds.

Using an average grower price of $1.10 per pound, 9 percent of the

California pistachio producers receive more than $550,000 annually. Only a portion of these producers would meet SBA's definition of a small agricultural producer.

The record shows that 12 California pistachio handlers (63 percent of the total) handle less than 1,000,000 pounds per year; 4 handlers (21%) handle between 1,000,000 and 10,000,000 pounds; and 3 handlers (16%) handle more than 10,000,000 pounds annually. The largest handler processes over 50 percent of industry production.

Using an average handler price of $1.80 per pound, 63 percent of the pistachio handlers would receive annual receipts of less than $1.8 million, 2 percent would receive between $1.8 and $18.0 million, and 16 percent would receive more than $18.0 million. At least 12 of the pistachio handlers (or 63 percent of the total) could be considered small businesses under SBA's definition.

Record evidence concerning pistachio production and handling costs provide an understanding of the California pistachio industry and potential impacts of implementing the proposed order. Farming pistachios is a costly investment with a significant delay in benefits and an unreliable crop yield.

Although increasing yields have led to an increasing overall value of California pistachio production, producers must maintain a level of return per pound harvested that covers the cost of production in order for their pistachio operations to remain economically viable. Witnesses testified that maintaining a high level of quality product in the market would lead to increasing consumer demand and greater stability in producer returns.

Evidence suggests that poor quality pistachios impact the demand, and the potential growth of demand, for pistachios. Characteristics routinely deemed as ''poor quality'' by customers of the California pistachio industry include small size, and excessive internal and external blemishes. Market studies and customer comments presented by handler witnesses demonstrate that the presence of poor quality pistachios in the marketplace significantly impacts demand in a negative way.

Minimizing the level of aflatoxin in California pistachios is another significant quality factor, as aflatoxin is a known carcinogen. Consumer concerns over aflatoxin can affect their perception of pistachio quality, and therefore negatively impact demand. Moreover, any market disturbances related to aflatoxin in pistachios, regardless of the geographic origin of those pistachios, could have a detrimental effect on the California pistachio industry. A regulatory program limiting the amount of aflatoxin in pistachios could be useful in bolstering consumer confidence in the quality of California pistachios.

Pistachio acreage has been consistently increasing in California, from just over 20,000 bearing acres in 1979 to 78,000 bearing acres in 2001. The number of non-bearing acres (*i.e.* acres less than 7 years old, not yet in full production) has also shown consistent growth in recent years, rising from 13,400 acres in 1995 to 23,500 acres in 2001, a 75 percent increase. Yield per acre has also been steadily rising. Over the 1976–1980 period, average yield per bearing acre measured 1,110 pounds; by 1996–2000, this average had increased to 2,512 pounds.

Higher yields and increasing acreage has resulted in increasing production. According to information submitted by the CPC, production in 2000 totaled 242 million pounds, a 64-percent increase over 1995 production, which totaled 148 million pounds. Moreover, witnesses at the hearing indicated that maturing acreage, absent any additional new plantings, will likely result in a 60-percent increase in California pistachio production over the coming years.

Several witnesses at the hearing testified that, in light of increasing production, future stability of market returns is reliant on continually increasing consumer demand for pistachios. These witnesses stated that strong consumer demand, which is ultimately related to consumer perceptions of product quality, is essential to the continued economic well being of the California pistachio industry. Moreover, witnesses discussed the importance of implementing a marketing order program that would provide them with a regulatory structure to monitor and assure that minimum quality standards are not compromised as production of California pistachios increases.

The relationship between product quality, consumer demand and producer returns in the pistachio industry was demonstrated at the hearing. Pistachio production is not only costly in terms of initial investment and cultural costs, but it is highly unpredictable in terms of producer returns. Between the initial processes of cleaning, hulling, sorting and drying, a significant portion of the initial volume harvested is reduced. This volume is further reduced as the handling process reaches its final stages of sorting for quality and final preparation for market. Witnesses explained that ultimate pistachio sales are based on approximately 30 percent of the volume initially harvested from the field. Because of this, witnesses stated that the process of extracting the highest quality portion of the harvest, and ensuring consumer satisfaction with that product, is crucial to determining the value of the crop.

Pistachio production is similar to other nut crops in that yield and total production vary substantially from year to year because of the alternate bearing nature of pistachio trees resulting in cyclical high and low production years. Total value and value per acre are generally higher in higher yielding years. Conversely, grower return per pound is generally higher in low yielding years.

Producer returns and total crop value are also dependent on the percentage of harvest that is either ''open shell'' or ''closed shell.'' Each harvest yields a certain percentage of nuts that have not naturally opened prior to cultivation. These nuts are classified as ''closed shell,'' ''shelling stock'' or ''non-splits,'' and have a lower market value than those nuts that are naturally split, or ''open shell.'' The proportion of open-shells is a key factor in year-to-year changes in the total value of production.

Economic evidence presented at the hearing, based on data from the National Agricultural Statistics Service (NASS) and the CPC, indicates that trends for total crop value and value per bearing acre have been increasing over the past 20 years. In 1980, the pistachio crop in California was valued at $55.8 million. By 2000, total crop value had increased more than four-fold, reaching $245 million. These gains are attributed to increases in both total pistachio producing acreage and yield per acre. Average value per bearing acre increased from $1,642 per acre in 1980–1984 to $2,665 per acre in 1996–2000.

According to CPC historical price data, price per pound has gradually decreased over the past 20 years, ranging from a high of $2.05 per pound in 1980 to a low of $0.99 per pound in 2001. According to the record, the proposed order would assist in improving producer returns for pistachios. The proposed order would not only assist in fortifying consumer demand by ensuring consumer satisfaction with product quality, but mandatory quality and aflatoxin requirements are also likely to boost domestic prices by culling lower quality pistachios, which tend to have price-depressing effects, from the market.

A University of California Cooperative Extension study presented as part of record evidence estimates total cost of production in 2001 at $2,643 per acre. According to industry data, the average grower return (value per bearing acre) for 1998–2001 was $2,619. This average revenue estimate is just below the Extension study's $2,643 estimate of typical cost. Record evidence indicates that over that 4-year period, the lowest value per bearing acre was $2,137 in 2001 and the highest was $3,207 in 2000.

Witnesses supplied an additional set of cost estimates, which ranged from a low-cost operation of $2,350 per acre to a high of $3,400 per acre. In their testimony, total costs of production were divided into three categories: the costs of orchard establishment, cultural costs and administrative costs. Establishment costs, or the overall cost to develop an acre of pistachios until revenues exceed growing expenses, were estimated at between $10,000 and $15,000, with an average tree maturation period of 7 years. In order to recover these investment costs, the hearing record states that producers generally target an 11% return on investment, estimated at between $1,100 and $1,650 per acre. Annual per acre cultural costs average between $1,100 and $1,600, once the trees are productive. Administrative costs include the cost of farm management and crop financing, and can vary between $150 and $200 per acre. The sum of cultural and administrative costs therefore range from $1,250 to $1,800.

Grower price per pound averaged approximately $1.10 between 1997 and 2001. Given that $1.10 average grower price and the cost estimates above, a producer would need to harvest an average of at least 2,000 pounds per acre to cover total production costs for the low-cost operation ($2,350 per acre). A producer would need to harvest at least 1,136 pounds per acre to cover the cultural and administrative costs of $1,250 per acre (not including a return on investment).

The CPC Annual Report for Crop Year 2001–2002 reveals that 6 out of 26 California counties with pistachio production yielded on average more than 2,000 pounds per acre between 1998 and 2001. These six counties, which together represented over 88 percent of total California pistachio production in 2000, are Colusa, Sutter, Madera, Fresno, Kings and Kern. Glenn, Butte, Placer, Yolo, Contra Costa, San Joaquin, Calaveras, Stanislaus, Merced, Tulare and Santa Barbara counties yield on average between 1,000 to 2,000 pounds per acre and represent roughly 12 percent of total state production. Shasta, Tehama, Yuba, Solano, Sacramento, San Luis Obispo, Los Angeles, San Bernardino and Riverside counties yield on average less than 1,000 pounds per acre and represent less than one percent of California pistachio production.

Given the assumptions made above, approximately 88 percent of the industry is covering total costs of production. Conversely, roughly 12 percent of the industry is currently covering cultural costs but not generating a return on their investment.

Simulation Model

Record evidence includes an economic analysis presented by Dr. Daniel Sumner, University of California-Davis on the potential impacts of the proposed marketing order provisions if the program were implemented. Dr. Sumner presented a cost-benefit analysis based on a simulation model, the purpose of which was to provide a framework for comparing costs of compliance to the benefits of improved quality through implementation of the standards.

Cost Estimates

Dr. Sumner's presentation focused on the regulatory features of the proposed marketing order: (1) Mandatory testing of pistachios for the presence of aflatoxin, with a maximum allowable tolerance of 15 ppb; and (2) mandatory minimum quality standards. The quality standards would specify minimum size and maximum allowable defects.

According to record testimony, the major costs associated with these features are the cost of aflatoxin testing and the cost of USDA presence in the handlers' plant to inspect and sample lots of pistachios. Expected benefits identified by the witnesses would be the increase in consumer confidence in pistachios as a result of aflatoxin regulation, and the combined increases in consumer demand for pistachios due to mandatory USDA regulation and stringent quality standards.

Dr. Sumner's analysis took into account many of the variables presented in testimony by other witnesses describing typical production and processing costs, and presented a weighted average cost computation for marketing order compliance. The average cost of compliance, as identified by several witnesses and reiterated in Dr. Sumner's analysis, is approximately one half cent per pound of domestic pistachio production, or $0.00525 per pound.

Record evidence suggests that the cost of having a USDA inspector in the plant, including mileage plus the standard fee per hour, is approximately $291 per day for the largest plants (which process about 80 percent of total production). Total production for the domestic market that would be processed by the largest plants (those that process over 10 million pounds annually) is estimated at 136 million pounds. If an average lot is 40,000 pounds (the most common lot size for testing cited by the largest handlers), then 3,400 lots would need to be tested to account for all 136 million pounds (166.67 million pounds times 80 per cent). If a USDA official were to test 5.5 lots per day, then 618 person-days would be needed to test all of the lots. Multiplying $291 per day times 618 person-days yields an annual cost of $180,000 for testing 136 million pounds. Dividing the $180,000 annual cost by 136 million pounds yields an estimated cost per pound of $0.0013 for having USDA personnel in the plant to sample and certify that the pistachios meet minimum quality standards. Testimony suggests that this cost estimate is on the high side, since many handlers would already have USDA personnel in their plants to perform other grading services besides certification of lots for minimum quality.

The cost of aflatoxin testing in the witnesses' simulation analysis is estimated at the current rate charged by a private laboratory ($75 per test). Given this rate information, the aflatoxin testing cost per pound would be $0.0019 ($75 divided by the average lot size of 40,000 pounds).

For the largest handlers, the combined cost of aflatoxin testing and paying for the USDA presence in the plants would be equal to the sum of the quality and aflatoxin cost figures outlined above ($0.0013 + $0.0019), or $0.0032 per pound. To account for imprecision of data and other incidental costs, Dr. Sumner's analysis employs a median cost per pound for marketing order compliance, which is slightly higher, or $0.005 per pound. The analysis further assumes that per unit costs are somewhat higher for smaller plants. Thus, median costs for two categories of smaller plants are estimated at $0.006 and $0.007.

Weighting these cost figures for the three different size categories of plants yields an overall median estimated cost per pound for compliance of $0.00525. In terms of economic theory, this cost increase is represented by a vertical shift in the supply curve of about one-half cent, as measured along the vertical axis in a supply-demand graph. The total direct cost of compliance is estimated at $875,000 in the median scenario ($0.00525 times 166.67 million pounds in the domestic market).

Benefit Estimates

The witness's economic analysis takes into account three separate demand benefits, which he considers distinct. The first, and largest, of the demand benefits is higher expected long run average demand due to the reduced chance of an aflatoxin event that would cause a major negative shock to demand. The mandatory aflatoxin testing under the marketing order would reduce the chance of a demand-decreasing market disturbance in the U.S.

Witnesses cited a 1996 pistachio aflatoxin case which occurred in Germany as an example of what could befall the U.S. pistachio industry if aflatoxin were not properly regulated. Widespread negative publicity about aflatoxin in foreign pistachios exported to Germany caused sales revenue to decline by 50 percent for a duration of three years or more. Witnesses estimate that a similar event in the United States could cost the industry over $300 million in gross revenue. Witnesses also pointed out that there were significant additional repercussions on pistachio sales worldwide as word of the German aflatoxin incident spread through the media of other nations, especially in Europe, affecting pistachio sales in those countries.

The witness's analysis assumes that an aflatoxin related market disturbance would cause a more moderate decrease, represented in the median simulation case as a 10 percent decline (18 cents) from the $1.80 per pound typical base price at the handler level.

By requiring aflatoxin testing for all pistachios destined for the domestic market, the marketing order would make the probability of an aflatoxin event less likely. As a starting point, witnesses argued that without mandatory aflatoxin testing through the proposed marketing order, there is a 5-percent annual probability of an aflatoxin related market disturbance. If such an incident were to occur, witnesses estimated that its impact would last for 3 years. Implementation of mandatory testing is then assumed to reduce the probability to 1 percent, a decline of 4 percentage points.

Mandatory testing under the marketing order therefore increases expected demand, or willingness to pay for pistachios, by $0.0216 per pound (4 per cent decline in probability times 18 cents times 3 years).

The witness's analysis includes two additional demand-side benefits. The witness asserts that USDA requirements convey a positive benefit in the market as reflected by the use of this claim in product promotion, labels, and displays. A median increase of $0.0025 in willingness to pay reflects a reasonably conservative estimate of the higher buyer confidence in pistachios due solely to USDA participation in the pistachio quality testing and certification process. The certification gives additional confidence in the quality of the product.

The third demand benefit is higher buyer perception of quality due to minimum standards. Witnesses assume a similarly small magnitude for this estimated increase in willingness to pay ($0.003 per pound).

Summing the median parameters for each of these three demand impacts, the increase in willingness to pay for pistachios supplied to the domestic market is a little under 3 cents per pound ($0.0271). In terms of economic theory, this figure represents an upward shift in the demand curve of nearly 3 cents, as measured along the vertical axis in a supply-demand graph. Most of the impact is from the first benefit, the reduced probability of aflatoxin being found in California pistachios.

Thus the median benefit in terms of increased per unit demand (willingness to pay) is estimated to be substantially larger than the estimated median per unit direct cost of marketing order compliance ($0.0271 versus $0.00525). Expected or average demand is higher, reflecting the lower probability of an aflatoxin event and the average quality and certification effects in the domestic market. Handlers would face higher costs to comply with the proposed requirements.

Simulation Results

These figures for increased cost and increased willingness to pay were combined with different demand and supply elasticities in the simulation model developed by Dr. Sumner to assess the net economic impact of marketing order implementation. The median elasticities used were unitary (−1.0 for demand and 1.0 for supply). The supply response that is modeled is a long run supply response (additional planting) due to the permanent change in market conditions resulting from the marketing order. These assumed elasticities are based on other prior econometric estimates for pistachios and other tree nuts. Witnesses cited a 1999 report by Lucinda Lewis of Competition Economics, Inc., ‘‘Charting a Direction for the U.S. Pistachio Industry,’’ which found a −1.14 demand elasticity for pistachios. According to the record testimony, the range of elasticities used in the simulation scenarios are consistent with published economic studies of supply and demand for pistachios and other tree nuts.

The simulation model solves a system of supply and demand equations for a new set of industry prices and quantities from marketing order implementation. As stated above, the total direct cost of compliance is $875,000. In the simulation, there is an upward shift in the market supply curve, representing increased costs to firms in the pistachio market. The magnitude of the price and quantity change from the shift in the supply curve is determined by the higher cost of production (compliance cost) and the elasticity of supply. The resulting computed (simulated) loss to the handler segment of the industry from higher expenses for marketing order compliance is $490,000.

This $490,000 differs from the previously stated $875,000 cost of compliance figure by the amount of an implied price increase and the small equalization effect on the smaller handlers that process 20 percent of the product.

The witness's analysis assumes that with minimum quality requirements the relative position of the smaller firms would improve to match those of other handlers. This is because prior to the new mandatory requirements, these firms are assumed to have fewer quality controls than most other firms, and thus end up selling nuts to the part of the market that buys lower quality nuts at lower prices. The equalization effect resulting from uniform minimum quality specifications is a small positive benefit that offsets some of the cost of compliance for the smaller firms.

On the demand side, the higher willingness to pay is $0.0216 per pound for the reduced probability of aflatoxin in California pistachios, and $0.0055 for the two additional demand-side benefits (higher buyer confidence from USDA certification and higher buyer perception of quality). The magnitude of the price and quantity change from the shift in the demand curve is determined by the higher willingness to pay and the elasticity of demand.

In the median simulation, the amount sold in the domestic market rises by 1.6 million pounds. The benefit to industry participants is the total value of this increase in domestic sales which is the 1.6 million pound increase in quantity sold multiplied by the higher expected price level resulting from the shifting of the supply and demand curves in the simulation of marketing order impacts.

Using the median supply and demand elasticities in the simulation model, and the median compliance cost and willingness to pay figures, the computed benefit to the handler portion of the market from the reduced chance of an aflatoxin market disturbance is $1.545 million dollars. The value of the two additional demand-side benefits is $.392 million dollars. The total benefit to handlers is thus $1.938 million dollars.

When the loss due to compliance-related expenses ($490,000) is factored in, the resulting net benefit to pistachio handlers from the marketing order is $1.448 million dollars. This $1.448 million dollar estimate of net benefit to handlers is the key result from the witness's cost-benefit analysis.

In economic theory terminology, this part of the simulation is measuring the change in producer surplus. Viewed in terms of a supply-demand graph, producer surplus is the area under the cost and above the supply curve. The $1.448 million dollar estimate of net benefit is a measure of the difference between producer surplus at the initial equilibrium (*e.g.* $1.80 average price at the handler level, or $1.10 at the grower level) and the new higher price and quantity after the supply and demand curves have been shifted to represent the median changes in cost (supply) and willingness to pay (demand).

TABLE 1.—SIMULATION OF PISTACHIO MARKETING ORDER IMPACTS ON PRODUCERS/HANDLERS

[Annual Net Costs and Benefits with Median Parameter Values]

Benefit 1: Reduced chance of aflatoxin event	$1,545,000
Benefit 2: USDA certification	178,000
Benefit 3:	
Improved quality perception	214,000
Total benefit	1,938,000
Impact of cost of compliance	−490,000
Net total	1,448,000

It should be noted that although the witness asserts that Benefit 2 and Benefit 3 are conceptually distinct, one could argue that there is significant overlap between the value of USDA certification and improved quality perception on the part of pistachio buyers and consumers. However, the assumed benefits are small in both cases, and if either of the benefit figures is eliminated, net estimated benefits to handlers still exceed one million dollars.

Cost-benefit studies which use economic welfare analysis also typically include consumer impacts, and the witness's economic analysis includes a parallel set of computations for the buyer/consumer segment of the pistachio industry. The largest demand-side benefit, the reduced chance of an aflatoxin event, is estimated at $2.586 million. The combined value of the two additional demand-side benefits is $.655 million, yielding a total benefit estimate of $3.241 million. Subtracting the estimated impact on buyers/consumers of introducing added costs of marketing order compliance ($245,000) yields a buyer/consumer net benefit estimate of $2.996 million. A key aspect of this economic analysis is that consumer willingness to pay for pistachios rises as consumer confidence improves from the higher quality standards imposed by the order. With the demand and supply elasticities used in the analysis, the benefits to the domestic buyers/consumers in this simulation are larger than benefits to the handler side of the market.

In economic theory terminology, this part of the simulation is measuring the change in consumer surplus. Viewed in terms of a supply-demand graph, consumer surplus is the area above the price and below the demand curve. The $2.996 million dollar estimate of net benefit is a measure of the difference between consumer surplus at the initial equilibrium and the new price and quantity after the supply and demand curves have been shifted to represent the median changes in cost (supply) and willingness to pay (demand).

Summing the producer/handler and buyer/consumer net benefits ($2.996 + $1.448) yields a $4.444 million median estimated value of the marketing order to the economy.

Estimated Impacts on Small Producers

The proposed marketing order would not impose any direct compliance costs on producers. The direct impact is on the handlers who would be required to pay for testing and inspection. Producers would be affected to the extent that they may have to discard more low quality nuts than previously, if they produce quantities of nuts below the proposed size and quality standard. Witnesses stated there is no evidence that the proportion of low quality nuts is correlated with farm size.

Additionally, the record shows that handler costs of compliance are typically reflected in handler payments to producers. Witnesses stated that the anticipated benefit derived from increased consumer demand would offset the cost of compliance to producers.

Witnesses stated that most producers sell to large handlers (which handle 80 percent of production). Distinguishing among handlers by size does not indicate different economic impacts on individual farms, which are distributed broadly across handlers.

Witnesses also pointed out that there is substantial inter-handler competition in the pistachio industry, with at least 10 handlers out of 19 competing for producers' pistachios (with the remainder presumably processing for their own account). Given the distribution of producers across processing firms and the level of competition, the overall cost-benefit results may be taken as the impact on the full size range of producers.

Based on a farm price of $1.10 and a handler price of $1.80, producers receive about 60 percent of the revenue in the industry, and are likely (given certain supply elasticities) to receive more than 60 percent of the estimated handler net benefits. Producer total gain (out of the estimated $1.448 million in net benefits to the handler segment) is thus at least $870,000 per year ($1.448 million times 0.60). This is distributed across producers in proportion to output, with no differential impact on smaller or larger producers.

Based on the hearing record, AMS therefore concludes that pistachio producers would benefit from implementation of the proposed order. Further, there is no evidence of differing economic impacts between small and large producers.

Estimated Impact on Small Handlers

Most compliance costs are uniform across handlers, but some differences could be correlated with the size of a handler's operation. Two relevant points are the number of lots ready to be tested per day and the lot size to be tested. Larger firms, which are more likely to have larger lot sizes for testing and to have more lots ready per day (up to about 5), may experience some savings relative to firms with smaller lot sizes and fewer lots to be tested at one time.

The proposed marketing order includes provisions to reduce compliance costs for small handlers. Firms that handle less than 1,000,000 pounds per year would be subject to simplified afaltoxin testing procedures. Additionally, they would be exempt from testing for remaining minimum quality requirements. This should reduce the expenses for smaller handlers.

Some other handlers, which process substantially more, may face somewhat higher costs for at least part of their production. Those handlers are likely, however, to have more than $5 million in total revenue, and would thus not be classified as small business entities.

Table 2 shows that the compliance costs and net economic impacts for different sizes of handlers. A positive net economic impact would exist for all handler groups.

TABLE 2.—DISTRIBUTION OF ECONOMIC EFFECTS ACROSS HANDLERS OF DIFFERENT SIZES

[Pistachio Marketing Order Simulation Results With Median Parameter Values]

Handler group*	Direct compliance cost	Net economic impact
Higher Volume/Lower Compliance Costs	−$667,000	$1,178,000
Medium Volume/Compliance Costs	−150,000	208,000
Lower Volume/Higher Compliance Costs	58,000	61,000
Total	875,000	1,447,000

*80%, 15%, and 5%, respectively, of total quantity of pistachios marketed annually.

The above table shows that the net economic impact is in direct proportion to the volume of pistachios handled by each handler group. For example, the largest handler group, accounting for 80 percent of the pistachios marketed, would reap about 81 percent of the benefits of the program. AMS therefore concludes that the program would not have a disproportionate impact on small entities.

The cost and benefit estimates presented above focus on a single set of results using median parameter values. The witness's economic analysis involved simulating a number of scenarios, using alternative values for compliance costs, benefits, and elasticities of supply and demand. All scenarios, even the low benefit, high cost scenarios, indicated positive net economic impacts.

The witness's analysis concludes that the proposed marketing order would require minimal adjustments in current processing activities and would yield large estimated benefits. The simulation results indicate that costs of compliance are small relative to benefits for all firms, and that both small and large entities are likely to benefit significantly. Producers are likely to share net producer benefits in proportion to production. Large and small handlers both gain from the marketing order, also in proportion to the volumes handled. Some of the smallest handlers could have larger net benefits per unit because of the provision allowing special lower-cost testing arrangements.

The witness's net benefit analysis represents a reasonable, plausible set of estimates of the economic impact of mandatory aflatoxin testing and minimum quality standards through promulgation of a Federal marketing order. The median cost and benefit figures explained during the hearing are considered to adequately represent estimates of the economic impact of implementation of the proposed program and its regulatory provisions.

The proposed order would impose some reporting and recordkeeping requirements on handlers. However, handler testimony indicated that the expected burden that would be imposed with respect to these requirements would be negligible. Most of the information that would be reported to the committee is already compiled by handlers for other uses and is readily available. Reporting and recordkeeping requirements issued under the peanut aflatoxin certification program (7 CFR part 996) impose an average annual burden on each regulated handler and importer of about 8 hours. It is reasonable to expect that a similar burden may be imposed under this proposed marketing order on the estimated 19 handlers of pistachios in California.

The Act requires that, prior to the issuance of a marketing order, a referendum be conducted among the affected producers to determine if they favor issuance of the order. The ballot material that would be used in conducting the referendum would be submitted to and approved by OMB before it is used. It is estimated that it would take an average of 10 minutes for each of the approximately 647 pistachio producers in California to complete the ballot. Additionally, it has been estimated that it would take approximately 10 minutes for each handler to complete the marketing agreement.

Therefore, in compliance with OMB regulations (5 CFR part 1320) which implement the Paperwork Reduction Act of 1995 (Pub. L. 104–13), the information collection and recordkeeping requirements that may be imposed by this order would be submitted to OMB for approval. Those requirements would not become effective prior to OMB review. Any recordkeeping and reporting requirements imposed would be evaluated against the potential benefits to be derived and it is expected that any added burden resulting from increased reporting and recordkeeping would not be significant when compared to those anticipated benefits derived from administration of the order.

The record evidence also indicates that the benefits to small as well as large handlers are likely to be greater than would accrue under the alternatives to the order proposed herein, namely no marketing order, or an order without the proposed combination of quality, size and aflatoxin regulation.

In determining that the proposed order and its provisions would not have a disproportionate economic on a substantial number of small entities, all of the issues discussed above were considered. Based on hearing record evidence and USDA's analysis of the economic information provided, the proposed order provisions have been carefully reviewed to ensure that every effort has been made to eliminate any unnecessary costs or requirements.

Although the proposed order may impose some additional costs and requirements on handlers, it is anticipated that the order will help to strengthen demand for California pistachios. Therefore, any additional costs would be offset by the benefits derived from expanded sales benefiting handlers and producers alike. Accordingly, it is determined that the proposed order would not have a disproportionate economic impact on a substantial number of small handlers or producers.

A 30-day comment period is provided to allow interested persons to respond to this proposed decision to effectuate a marketing order. Thirty days is deemed appropriate so that any marketing order resulting from this rulemaking process may be implemented as soon as possible at the beginning of the nearest marketing year. A 60-day comment period on the information collection burden is deemed appropriate as any paperwork burden imposed by this action will not become effective until the process is finalized. All written exceptions and comments timely received will be considered and a grower referendum will be conducted before these proposals are implemented.

Civil Justice Reform

The marketing agreement and order proposed herein have been reviewed under Executive Order 12988, Civil Justice Reform. They are not intended to have retroactive effect. If adopted, the proposed order would not preempt any State or local laws, regulations, or policies, unless they present an irreconcilable conflict with this proposal.

The Act provides that administrative proceedings must be exhausted before parties may file suit in court. Under section 608c(15)(A) of the Act, any handler subject to an order may file with the Department a petition stating that the order, any provision of the order, or any obligation imposed in connection with the order is not in accordance with law and request a modification of the order or to be exempted there from. A handler is afforded the opportunity for a hearing on the petition. After the hearing, the USDA would rule on the petition. The Act provides that the district court of the United States in any district in which the handler is an inhabitant, or has his or her principal place of business, has jurisdiction to review the Department's ruling on the petition, provided an action is filed not later than 20 days after the date of the entry of the ruling.

Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. Chapter 35), AMS announces its intention to request an approval of a new information collection for the marketing order regulating pistachios grown in California.

Title: Pistachios Grown in California.

OMB Number: 0581–NEW.

Expiration Date of Approval: To be assigned by OMB.

Type of Request: Intent to establish a new information collection.

Abstract: The information collection requirements in this request are essential to carry out the intent of the Act, to provide the respondents the type of service they request, and to administer the California pistachio marketing order program.

The California pistachio marketing order would authorize standards for quality of pistachios produced and handled in California by establishing a maximum aflatoxin tolerance level, maximum limits for defects, a minimum size requirement, and mandatory inspection and certification. AMS is the agency that would provide oversight of the order, and any administrative rules and regulations issued under the program.

The Department must determine if sufficient producer support exists within the industry to initially establish the proposed marketing order. If the order were established, the USDA could also, given recommendation by the committee and adequate support by the industry, implement formal rulemaking to amend the order. Further, a continuance referendum would be conducted every 6 years to determine ongoing industry support for the order. In all of these instances, ballot information would be collected from producers and compiled in aggregate for purposes of determining producer support for the order (or any amendment to the order).

Upon implementation of the order or during amendatory proceedings, handlers would be asked to sign a marketing agreement to indicate their willingness to comply with the provisions of the new or amended order. AMS would also provide a certificate of resolution for each handler organization to sign, documenting the handler's support of the marketing agreement and order.

If the proposed order is established, handler and producer nomination forms, ballots, and confidential qualification and acceptance statements will be used to nominate and appoint the committee members.

California pistachio producers and handlers would be nominated by their peers to serve as representatives on the committee. Each producer and handler would have the opportunity to submit a nomination form with the names of individuals to be considered for nomination.

Individuals who are nominated and wish to stand for election would be required to complete a confidential qualification and acceptance statement before the election. If qualified, the nominees would be placed on a nomination ballot.

Producers and handlers would vote for the candidate(s) of their choice using the producer and handler nomination ballots. Names of candidates receiving the most votes would be submitted to AMS for appointment as committee members and alternate members. The producer and handler members of the committee would nominate a public member and alternate public member. Each would complete qualification and acceptance statement before being recommended to AMS for appointment.

The forms covered under this information collection request submission of minimum information necessary to ascertain producer support for implementing the proposed order and to appoint initial committee members. Additional reporting and recordkeeping requirements may subsequently be recommended by the committee for its use in administering the order. The burden imposed by any additional requirements would be submitted for approval by the OMB.

The information collected would be used only by authorized representatives of USDA, including AMS, Fruit and Vegetable Programs regional and headquarters' staff, and authorized employees of the committee, if established. Section 608(d)(2) of the Act provides that all information would be kept confidential.

Total Annual Estimated Burden

The total burden for the proposed information collection under the order is as follows:

Estimate of Burden: Public reporting burden for this collection of information is estimated to average 15 minutes per response.

Estimated Number of Respondents: 668 (647 producers, 19 handlers and the public member and alternate nominee).

Estimated Number of Responses per Respondent: .77

Estimated Total Annual Burden on Respondents: 133 hours.

Estimated Annual Burden for Each Form

For each new form, the proposed request for approval of new information collections under the order are as follows:

FV–240 Producer's Referendum Ballot (promulgation and continuance). Producers would use this ballot to vote whether they favor establishment of the order and, once every 6 years, whether they want the order to continue in effect. For the purpose of this calculation, it is estimated that 450 pistachio producers (75 percent of the total) would vote in the promulgation referendum and in the continuance referenda.

Estimate of Burden: Public reporting burden for this collection of information is estimated to average 20 minutes per response.

Respondents: California pistachio producers.

Estimated Number of Respondents: 450.

Estimated Number of Responses per Respondent: Once every 6 years.

Estimated Total Annual Burden on Respondents: 25 hours.

FV–241 Cooperative Association of Producers Referendum Ballot (promulgation and continuance). This ballot would be used to register the cooperative's vote on promulgation or continuance of the marketing order. At the time of this promulgation proceeding, there is only 1 pistachio cooperative registered in the production area.

Estimate of Burden: Public reporting burden for this collection of information is estimated to average 20 minutes per response.

Respondents: California pistachio cooperative.

Estimated Number of Respondents: 1.

Estimated Number of Responses per Respondent: Once every 6 years.

Estimated Total Annual Burden on Respondents: 3 minutes.

FV–242 Marketing Agreement. Handlers would use this form to indicate their willingness to comply with the provisions of the order. The Marketing Agreement would be completed if the proposed order is implemented and in any future amendment of the order.

Estimate of Burden: Public reporting burden for this collection of information is estimated to average 5 minutes per response.

Respondents: California pistachio handlers.

Estimated Number of Respondents: 19.

Estimated Number of Responses per Respondent: Once every 6 years.

Estimated Total Annual Burden on Respondents: 16 minutes.

FV–242A Certificate of Resolution. This would document corporate handlers' support for the order and marketing agreement. The Marketing Agreement would be completed if the proposed order is implemented and in any future amendment of the order.

Estimate of Burden: Public reporting burden for this collection of information is estimated to average 5 minutes per response.

Respondents: Incorporated pistachio handlers.

Estimated Number of Respondents: 19.

Estimated Number of Responses per Respondent: Once every 6 years.

Estimated Total Annual Burden on Respondents: 16 minutes.

FV–243 Administrative Committee for Pistachios Confidential Producer/Handler and Public Member Qualification and Acceptance Statement. There are 11 members and 11 alternate members on the committee. Each year after the initial committee is seated, half of the 22 members would be replaced with new members. This form would be used by candidates for nomination to provide their qualifications to serve on the committee. For the purpose of this calculation, it is estimated that 30 individuals will agree to be candidates to serve on the committee.

Estimate of Burden: Public reporting burden for this collection of information is estimated to average 10 minutes per response.

Respondents: California pistachio producers, handlers and public member nominees.

Estimated Number of Respondents: 30.

Estimated Number of Responses per Respondent: 1.

Estimated Total Annual Burden on Respondents: 5 hours.

FV–244 Handler Members and Alternate Handler Members' Ballot. Each handler would use the ballot to vote on handler member nominees to serve on the committee.

Estimate of Burden: Public reporting burden for this collection of information is estimated to average 5 minutes per response.

Respondents: California pistachio handlers.

Estimated Number of Respondents: 19.

Estimated Number of Responses per Respondent: 1.

Estimated Total Annual Burden on Respondents: 1.5 hours.

FV–245 Producer Members and Alternate Producer Members Nomination Form. Pistachio producers would use this form to nominate themselves or other producers to serve on the committee. For the purpose of this calculation, it is estimated that 50 producers will offer nominations.

Estimate of Burden: Public reporting burden for this collection of information is estimated to average 20 minutes per response.

Respondents: California pistachio producers.

Estimated Number of Respondents: 50.

Estimated Number of Responses per Respondent: 1.

Estimated Total Annual Burden on Respondents: 17 hours.

FV–245A Handler Members and Alternate Handler Members' Nomination Form. Pistachio handlers would use this form to nominate themselves or other handlers to serve on the committee. For the purpose of this calculation, it is estimated that 10 handlers will offer nominations.

Estimate of Burden: Public reporting burden for this collection of information is estimated to average 20 minutes per response.

Respondents: California pistachio handlers.

Estimated Number of Respondents: 10.

Estimated Number of Responses per Respondent: 1.

Estimated Total Annual Burden on Respondents: 3.3 hours.

FV–246 Producer Member and Alternate Producer Member Ballot. Pistachio producers would use this ballot to vote on their choice of nominees to serve on the committee. For the purpose of this calculation, it is estimated that 325 producers (50 percent of all producers) will vote in nomination elections.

Estimate of Burden: Public reporting burden for this collection of information is estimated to average 15 minutes per response.

Respondents: California pistachio producers.

Estimated Number of Respondents: 325.

Estimated Number of Responses per Respondent: 1.

Estimated Total Annual Burden on Respondents: 81 hours.

If this marketing order program is approved by producers in referendum and established by USDA, the committee could recommend to the Department other forms (such as monthly handler reports of acquisitions or dispositions of substandard pistachios) which would be needed to administer the order. All such forms would be subject to USDA and OMB review and approval.

Comments: Comments are invited on: (1) Whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information would have practical utility; (2) the accuracy of the agency's estimate of the burden of the proposed collection of information, including the validity of the methodology and assumptions used; (3) ways to enhance the quality, utility, and clarity of the information to be collected; and (4) ways to minimize the burden of the collection of information on those who are to respond, including the use of appropriate automated, electronic, mechanical, or other technological collection techniques or other forms of information technology.

Comments should reference OMB No. 0581–NEW and the California pistachio marketing order, and be sent to USDA in care of the Docket Clerk at the previously mentioned address. All comments received will be available for public inspection during regular business hours at the same address.

All responses to this notice will be summarized and included in the request for OMB approval of the above-described forms. All comments will become a matter of public record.

Rulings on Proposed Findings and Conclusions

Briefs, proposed findings and conclusions, and the evidence in the record were considered in making the findings and conclusions set forth in this recommended decision. To the extent that the suggested findings and conclusions filed by interested persons are inconsistent with the findings and conclusions of this recommended decision, the requests to make such findings or to reach such conclusions are denied.

General Findings

(1) The proposed marketing agreement and order and all of the terms and conditions thereof, would tend to effectuate the declared policy of the Act;

(2) The proposed marketing agreement and order regulate the handling of pistachios in California in the same manner as, and are applicable only to, persons in the respective classes of commercial and industrial activity specified in the marketing agreement and order upon which a hearing has been held;

(3) The proposed marketing agreement and order are limited in their application to the smallest regional production area which is practicable, consistent with carrying out the declared policy of the Act, and the issuance of several orders applicable to subdivision of the production area would not effectively carry out the declared policy of the Act;

(4) The proposed marketing agreement and order prescribe, insofar as practicable, such different terms applicable to different parts of the production area as are necessary to give due recognition to the differences in the production and marketing of pistachios grown in the production area; and

(5) All handling of pistachios grown in California as defined in the proposed marketing agreement and order, is in the current of interstate or foreign commerce or directly burdens, obstructs, or affects such commerce.

Provisions of the proposed marketing agreement and order follow. Those sections identified with an asterisk (*) apply only to the proposed marketing agreement.

List of Subjects in 7 CFR Part 983

Marketing agreements, Pistachios, Reporting and recordkeeping requirements.

Title 7, chapter IX is proposed to be amended by adding part 983 to read as follows:

PART 983—PISTACHIOS GROWN IN CALIFORNIA

Subpart—Order Regulating Handling

Definitions

*Sections identified with an asterisk (*) apply only to the proposed marketing agreement.

Authority: 7 U.S.C. 601–674.

Subpart—Order Regulating Handling

Definitions

§ 983.1 Accredited laboratory.

An *accredited laboratory* is a laboratory that has been approved or accredited by the U.S. Department of Agriculture for testing aflatoxin.

§ 983.2 Act.

Act means Public Act No. 10, 73rd Congress (May 12, 1933), as amended and as re-enacted and amended by the Agricultural Marketing Order Act of 1937, as amended (48 Stat. 31, as amended; 7 U.S.C. 601 *et seq.*).

§ 983.3 Affiliation.

Affiliation. This term normally appears as ''affiliate of'', or ''affiliated with'', and means a person such as a producer or handler who is: a producer or handler that directly, or indirectly through one or more intermediaries, owns or controls, or is controlled by, or is under common control with the producer or handler specified; or a producer or handler that directly, or indirectly through one or more intermediaries, is connected in a proprietary capacity, or shares the ownership or control of the specified producer or handler with one or more other producers or handlers. As used in this part, the term *control* (including the terms *controlling, controlled by,* and *under the common control with*) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a handler or a producer, whether through voting securities, membership in a cooperative, by contract or otherwise.

§ 983.4 Aflatoxin.

Aflatoxin is one of a group of mycotoxins produced by the molds *Aspergillus flavus* and *Aspergillus parasiticus.* Aflatoxins are naturally occurring compounds produced by molds, which can be spread in improperly processed and stored nuts, dried fruits and grains.

§ 983.5 Aflatoxin inspection certificate.

Aflatoxin inspection certificate is a certificate issued by an accredited laboratory or by a USDA laboratory.

§ 983.6 Assessed weight.

Assessed weight means pounds of pistachios, with the weight computed at 5 percent moisture, received for processing by a handler within each production year: *Provided,* That for loose kernels, the actual weight shall be multiplied by two to obtain an inshell weight; or based on such other elements as may be recommended by the committee and approved by the Secretary.

§ 983.7 Certified pistachios.

Certified pistachios are those for which aflatoxin inspection and minimum quality certificates have been issued.

§ 983.8 Committee.

Committee means the administrative committee for pistachios established pursuant to § 983.32.

§ 983.9 Confidential data or information.

Confidential data or information submitted to the committee consists of data or information constituting a trade secret or disclosure of the trade position, financial condition, or business operations of a particular entity or its customers.

§ 983.10 Department or USDA.

Department or USDA means the United States Department of Agriculture.

§ 983.11 Districts.

(a) *Districts* shall consist of the following:

(1) *District 1* consists of Tulare, Kern, San Bernardino, San Luis Obispo, Santa Barbara, Ventura, Los Angeles, Orange, Riverside, San Diego, and Imperial Counties of California.

(2) *District 2* consists of Kings, Fresno, Madera, and Merced Counties of California.

(3) *District 3* consists of all counties in California where pistachios are produced that are not included in Districts 1 and 2.

(b) With the approval of the Secretary, the boundaries of any district may be changed by the committee, to ensure proper representation. The boundaries need not coincide with county lines. In addition, the boundaries in the production area may be adjusted to conform to changes to the boundaries of the districts established for those of the California Pistachio Commission upon the recommendation of the committee and approval of the Secretary.

§ 983.12 Domestic shipments.

Domestic shipments means shipments to the fifty states of the United States or to territories of the United States and the District of Columbia.

§ 983.13 Edible pistachios.

Edible pistachios are those that do not exceed the level of defects under § 983.38 and § 983.39.

§ 983.14 Handle.

Handle means to engage in:

(a) Receiving pistachios;

(b) Hulling and drying pistachios;

(c) Further preparing pistachios by sorting, sizing, shelling, roasting, cleaning, salting, and/or packaging for marketing in or transporting to any and all markets in the current of interstate or foreign commerce; and/or

(d) Placing pistachios into the current of commerce from within the production area to points outside thereof: *Provided,* however, that transportation within the production area between handlers and from the orchard to the processing facility is not handling.

§ 983.15 Handler.

Handler means any person who handles pistachios.

§ 983.16 Inshell pistachios.

Inshell pistachios means pistachios that have a shell that has not been removed.

§ 983.17 Inspector.

Inspector means any inspector authorized by the USDA to inspect pistachios.

§ 983.18 Lot.

Lot means any quantity of pistachios that is submitted for testing purposes under this part.

§ 983.19 Minimum quality requirements.

Minimum quality requirements are permissible maximum defects and minimum size levels for inshell pistachios and kernels specified in § 983.39.

§ 983.20 Minimum quality certificate.

Minimum quality certificate is a certificate issued by the USDA or Federal/State Inspection Service.

§ 983.21 Part and subpart.

Part means the order regulating the handling of pistachios grown in the State of California, and all rules, regulations and supplementary orders issued there under. The aforesaid order regulating the handling of pistachios grown in California shall be a subpart of such part.

§ 983.22 Person.

Person means an individual, partnership, limited liability corporation, corporation, trust, association, or any other business unit.

§ 983.23 Pistachios.

Pistachios means the nuts of the pistachio tree of the genus *Pistacia vera* grown in the production area whether inshell or shelled.

§ 983.24 Processing.

Processing means hulling and drying pistachios in preparation for market.

§ 983.25 Producer.

Producer means any person engaged within the production area in a proprietary capacity in the production of pistachios for sale.

§ 983.26 Production area.

Production area means the State of California.

§ 983.27 Production year.

Production year is synonymous with ''fiscal period'' and means the period beginning on September 1 and ending on August 31 of each year or such other period as may be recommended by the committee and approved by the Secretary. Pistachios harvested and received in August of any year shall be applied to the subsequent production year for marketing order purposes.

§ 983.28 Proprietary capacity.

Proprietary capacity means the capacity or interest of a producer or handler that, either directly or through one or more intermediaries, is a property owner together with all the appurtenant rights of an owner including the right to vote the interest in that capacity as an individual, a shareholder, member of a cooperative, partner, trustee or in any other capacity with respect to any other business unit.

§ 983.29 Secretary.

Secretary means the Secretary of Agriculture of the United States or any officer or employee of the United States Department of Agriculture who is, or who may hereafter be, authorized to act in his/her stead.

§ 983.30 Shelled pistachios.

Shelled pistachios means pistachio kernels, or portions of kernels, after the pistachio shells have been removed.

§ 983.31 Substandard pistachios.

Substandard pistachios means pistachios, inshell or shelled, which do not comply with the maximum aflatoxin and/or minimum quality regulations of this part.

Administrative Committee

§ 983.32 Establishment and membership.

There is hereby established an administrative committee for pistachios to administer the terms and provisions of this part. This committee, consisting of eleven (11) member positions, each of whom shall have an alternate, shall be allocated as follows:

(a) *Handlers.* Two of the members shall represent handlers, as follows:

(1) One handler member nominated by one vote for each handler; and

(2) One handler member nominated by voting based on each handler casting one vote for each ton (or portion thereof) of the assessed weight of pistachios processed by such handler during the two production years preceding the production year in which the nominations are made.

(b) *Producers.* Eight members shall represent producers. Producers within the respective districts shall nominate four producers from District 1, three producers from District 2 and one producer from District 3. The Secretary, upon recommendation of the committee, may reapportion producer membership among the districts to ensure proper representation.

(c) *Public member.* One member shall be a public member who is neither a producer nor a handler and shall have all the powers, rights and privileges of any other member of the committee. The public member and alternate public member shall be nominated by the committee and selected by the Secretary.

§ 983.33 Initial members and nomination of successor members.

Nomination of committee members and alternates shall follow the procedure set forth in this section or as may be changed as recommended by the committee and approved by the Secretary.

(a) *Initial members.* Nominations for initial grower and handler members shall be conducted by the Secretary by either holding meetings of handlers and producers, or by mail.

(b) *Successor members.* Subsequent to the first nomination of committee members under this part, persons to be nominated to serve on the committee as producer or handler members shall be selected pursuant to nomination procedures that shall be established by the committee with the approval of the Secretary: *Provided,* That:

(1) Any qualified individuals who seek nomination as a producer member shall submit to the committee an intent to seek office in one designated district on such form and with such information as the committee shall designate; ballots, accompanied by the names of all such candidates, with spaces to indicate voters' choices and spaces for write-in candidates, together with voting instructions, shall be mailed to all producers who are on record with the committee within the respective districts; the person(s) receiving the highest number of votes shall be the member nominee(s) for that district, and the person(s) receiving the second highest number of votes shall be the alternate member nominee(s). In case of a tie vote, the nominee shall be selected by a drawing.

(2) Any qualified individuals who seek nomination as a handler member shall submit to the committee an intent to seek office with such information as the committee shall designate; ballots, accompanied by the names of all such candidates, with spaces to indicate voters' choices and spaces for write-in candidates, together with voting instructions, shall be mailed to all handlers who are on record with the committee. For the first handler member seat, the person receiving the highest number of votes shall be the handler member nominee for that seat, and the person receiving the second highest number of votes shall be the alternate member nominee. For the second handler member seat, the person receiving the highest number of votes representing handler volume shall be the handler member nominee for that seat, and the person receiving the second highest number of votes representing handler volume shall be the alternate member nominee. In case of a tie vote, the nominee shall be selected by a drawing.

(c) *Handlers.* Only handlers, including duly authorized officers or employees of handlers, may participate in the nomination of the two handler member nominees and their alternates. Nomination of the two handler members and their alternates shall be as follows:

(1) For one handler member nomination, each handler entity shall be entitled to one vote;

(2) For the second handler member nomination, each handler entity shall be entitled to cast one vote respectively for each ton of assessed weight of pistachios processed by that handler during the two production years preceding the production year in which the nominations are made. For the purposes of nominating handler members and alternates by volume, the assessed weight of pistachios shall be credited to the handler responsible under the order for the payment of assessments of those pistachios. The committee with the approval of the Secretary, may revise the handler representation on the committee if the committee ceases to be representative of the industry.

(d) *Producers.* Only producers, including duly authorized officers or employees of producers, may participate in the nomination of nominees for producer members and their alternates. Each producer shall be entitled to cast only one vote, whether directly or through an authorized officer or employee, for each position to be filled in the district in which the producer produces pistachios. If a producer is engaged in producing pistachios in more than one district, such producer shall select the district in which to participate in the nomination. If a person is both a producer and a handler of pistachios, such person may participate in both producer and handler nominations, provided, however, that a single member may not hold concurrent seats as both a producer and handler.

(e) *Member's affiliation.* Not more than two members and not more than two alternate members shall be persons employed by or affiliated with producers or handlers that are affiliated with the same handler and/or producer. Additionally, only one member and one alternate in any one district representing producers and only one member and one alternate representing handlers shall be employed by, or affiliated with the same handler and/or producer. No handler, and all of its affiliated handlers, can be represented by more than one handler member.

(f) *Cooperative affiliation.* In the case of a producer cooperative, a producer shall not be deemed to be connected in a proprietary capacity with the cooperative notwithstanding any outstanding retains, contributions or financial indebtedness owed by the cooperative to a producer if the producer has not marketed pistachios through the cooperative during the current and one preceding production year. A cooperative that has as its members one or more other cooperatives that are handlers shall not be considered as a handler for the purpose of nominating or voting under this part.

(g) *Alternate members.* Each member of the committee shall have an alternate member to be nominated in the same manner as the member. Any alternate serving in the same district as a member where both are employed by, or connected in a proprietary capacity with the same corporation, firm, partnership, association, or business organization, shall serve as the alternate to that member. An alternate member, in the absence of the member for whom that alternate is selected shall serve in place of that member on the committee, and shall have and be able to exercise all the rights, privileges, and powers of the member when serving on the committee. In the event of death, removal, resignation, or the disqualification of a member, the alternate shall act as a member on the committee until a successor member is selected and has been qualified.

(h) *Selection by Secretary.* Nominations under paragraph (g) of this section received by the committee for all handler and producer members and alternate member positions shall be certified and sent to the Secretary at least 60 days prior to the beginning of each two-year term of office, together with all necessary data and other information deemed by the committee to be pertinent or requested by the Secretary. From those nominations, the Secretary shall select the ten producer and handler members of the committee and an alternate for each member.

(i) *Acceptance.* Each person to be selected by the Secretary as a member or as an alternate member of the committee shall, prior to such selection, qualify by advising the Secretary that if selected, such person agrees to serve in the position for which that nomination has been made.

(j) *Failure to nominate.* If nominations are not made within the time and manner specified in this part, the Secretary may, without regard to nominations, select the committee members and alternates qualified to serve on the basis of the representation provided for in § 983.32.

(k) *Term of office.* Selected members and alternate members of the committee shall serve for terms of two years: *Provided,* That four of the initially selected producer members and one handler member and their alternates shall, by a drawing, be seated for terms of one year so that approximately half of the memberships' terms expire each year. Each member and alternate member shall continue to serve until a successor is selected and has qualified. The term of office shall begin on July 1st of each year. Committee members and alternates may serve up to four consecutive, two-year terms of office. In no event shall any member or alternate serve more than eight consecutive years on the committee. For purposes of determining when a member or alternate has served four consecutive terms, the accrual of terms shall begin following any period of at least twelve consecutive months out of office.

(l) *Qualifications.* (1) Each producer member and alternate shall be, at the time of selection and during the term of office, a producer or an officer, or employee, of a producer in the district for which nominated.

(2) Each handler member and alternate shall be, at the time of selection and during the term of office, a handler or an officer or employee of a handler.

(3) Any member or alternate member who at the time of selection was employed by or affiliated with the person who is nominated, that member shall, upon termination of that relationship, become disqualified to serve further as a member and that position shall be deemed vacant.

(4) No person nominated to serve as a public member or alternate public member shall have a financial interest in any pistachio growing or handling operation.

(m) *Vacancy.* Any vacancy on the committee occurring by the failure of any person selected to the committee to qualify as a member or alternate member due to a change in status making the member ineligible to serve, or due to death, removal, or resignation, shall be filled, by a majority vote of the committee for the unexpired portion of the term. However, that person shall fulfill all the qualifications set forth in this part as required for the member whose office that person is to fill. The qualifications of any person to fill a vacancy on the committee shall be certified in writing to the Secretary. The Secretary shall notify the committee if the Secretary determines that any such person is not qualified.

(n) The committee, with the approval of the Secretary, may issue rules and regulations implementing §§ 983.32, 983.33 and 983.34.

§ 983.34 Procedure.

(a) *Quorum.* A quorum of the committee shall be any seven voting committee members. The vote of a majority of members present at a meeting at which there is a quorum shall constitute the act of the committee: *Provided,* That actions of the committee with respect to the following issues shall require at least seven concurring votes of the voting members regarding any recommendation to the Secretary for adoption or change in:

(1) Minimum quality levels;

(2) Aflatoxin levels;

(3) Inspection programs;

(4) The establishment of the committee.

(b) *Voting.* Members of the committee may participate in a meeting by attendance in person or through the use of a conference telephone or similar communication equipment, as long as all members participating in such a meeting can communicate with one another. An action required or permitted to be taken by the committee may be taken without a meeting, if all members of the committee shall consent in writing to that action.

(c) *Compensation.* The members of the committee and their alternates shall serve without compensation, but members and alternates acting as members shall be allowed their necessary expenses: *Provided,* That the committee may request the attendance of one or more alternates not acting as members at any meeting of the committee, and such alternates may be allowed their necessary expenses; and, *Provided further,* That the public member and the alternate for the public member may be paid reasonable compensation in addition to necessary expenses.

§ 983.35 Powers.

The committee shall have the following powers:

(a) To administer the provisions of this part in accordance with its terms;

(b) To make and adopt bylaws, rules and regulations to effectuate the terms and provisions of this part with the approval of the Secretary;

(c) To receive, investigate, and report to the Secretary complaints of violations of this part; and

(d) To recommend to the Secretary amendments to this part.

§ 983.36 Duties.

The committee shall have, among others, the following duties:

(a) To adopt bylaws and rules for the conduct of its meetings and the selection of such officers from among its membership, including a chairperson and vice-chairperson, as may be necessary, and define the duties of such officers; and adopt such other bylaws, regulations and rules as may be necessary to accomplish the purposes of the Act and the efficient administration of this part;

(b) To employ or contract with such persons or agents as the committee deems necessary and to determine the duties and compensation of such persons or agents;

(c) To select such subcommittees as may be necessary;

(d) To submit to the Secretary a budget for each fiscal period, prior to the beginning of such period, including a report explaining the items appearing therein and a recommendation as to the rate of assessments for such period;

(e) To keep minutes, books, and records which will reflect all of the acts and transactions of the committee and which shall be subject to examination by the Secretary;

(f) To prepare periodic statements of the financial operations of the committee and to make copies of each statement available to producers and handlers for examination at the office of the committee;

(g) To cause its financial statements to be audited by a certified public accountant at least once each fiscal year and at such times as the Secretary may request. Such audit shall include an examination of the receipt of assessments and the disbursement of all funds. The committee shall provide the Secretary with a copy of all audits and shall make copies of such audits, after the removal of any confidential individual or handler information that may be contained in them, available for examination at the offices of the committee;

(h) To act as intermediary between the Secretary and any producer or handler with respect to the operations of this part;

(i) To investigate and assemble data on the growing, handling, shipping and marketing conditions with respect to pistachios;

(j) To apprise the Secretary of all committee meetings in a timely manner;

(k) To submit to the Secretary such available information as the Secretary may request;

(l) To investigate compliance with the provisions of this part;

(m) To provide, through communication to producers and handlers, information regarding the activities of the committee and to respond to industry inquiries about committee activities;

(n) To oversee the collection of assessments levied under this part;

(o) To borrow such funds, subject to the approval of the Secretary and not to exceed the expected expenses of one fiscal year, as are necessary for administering its responsibilities and obligations under this part.

Marketing Policy

§ 983.37 Marketing policy.

Prior to August 1st each year, the committee shall prepare and submit to the Secretary a report setting forth its recommended marketing policy covering quality regulations for the pending crop. In the event it becomes advisable to modify such policy, because of changed crop conditions, the committee shall formulate a new policy and shall submit a report thereon to the Secretary. In developing the marketing policy, the committee shall give consideration to the production, harvesting, processing and storage conditions of that crop. The committee may also give consideration to current prices being received and the probable general level of prices to be received for pistachios by producers and handlers. Notice of the committee's marketing policy, and of any modifications thereof, shall be given promptly by reasonable publicity, to producers and handlers.

Regulations

§ 983.38 Aflatoxin levels.

(a) *Maximum level.* No handler shall ship for domestic human consumption, pistachios that exceed an aflatoxin level of more than 15 ppb. All shipments must also be covered by an aflatoxin inspection certificate. Pistachios that fail to meet the aflatoxin requirements shall be disposed in such manner as described in Failed lots/rework procedure of this part.

(b) *Change in level.* The committee may recommend to the Secretary changes in the aflatoxin level specified in this section. If the Secretary finds on the basis of such recommendation or other information that such an adjustment of the aflatoxin level would tend to effectuate the declared policy of the Act, such change shall be made accordingly.

(c) *Transfers between handlers.* Transfers between handlers within the production area are exempt from the aflatoxin regulation of this section.

(d) *Aflatoxin testing procedures.* To obtain an aflatoxin inspection certificate, each lot to be certified shall be uniquely identified, be traceable from testing through shipment by the handler and be subjected to the following:

(1) *Samples for testing.* Prior to testing, a sample shall be drawn from each lot and divided between those pistachios for aflatoxin testing and those for minimum quality testing (''lot samples'') in sufficient weight to comply with Table 1, Table 2 and Table 4 of this part.

(2) *Test samples for aflatoxin.* Prior to submission of samples to an accredited laboratory for aflatoxin analysis, three samples shall be created equally from the pistachios designated for aflatoxin testing in compliance with the requirements of Tables 1 and 2 of this paragraph (d)(2) (''test samples''). The test samples shall be prepared by, or under the supervision of, an inspector, or as approved under an alternative USDA-recognized inspection program. The test samples shall be designated by an inspector as Test Sample #1, Test Sample #2, and Test Sample #3. Each sample shall be placed in a suitable container, with the lot number clearly identified, and then submitted to an accredited laboratory. The gross weight of the inshell lot sample for aflatoxin testing and the number of samplings required are shown in Table 1 of this paragraph (d)(2). The gross weight of the kernel lot sample for aflatoxin testing and the number of incremental samples required is shown in Table 2 of this paragraph (d)(2).

TABLE 1.—INSHELL PISTACHIO LOT SAMPLING INCREMENTS FOR AFLATOXIN CERTIFICATION

Lot weight (lbs.)	Number of incremental samples for the lot sample	Total weight of lot sample (kilograms)	Weight of test sample (kilograms)
220 or less	10	3.0	1.0
221–440	15	4.5	1.5
441–1100	20	6.0	2.0
1101–2200	30	9.0	3.0
2201–4400	40	12.0	4.0
4401–11,000	60	18.0	6.0
11,001–22,000	80	24.0	8.0
22,001–150,000	100	30.0	10.0

TABLE 2.—SHELLED PISTACHIO KERNEL LOT SAMPLING INCREMENTS FOR AFLATOXIN CERTIFICATION

Lot weight (lbs.)	Number of incremental samples for the lot sample	Total weight of lot sample (kilograms)	Weight of test sample (kilograms)
220 or less	10	1.5	.5
221–440	15	2.3	.75
441–1100	20	3.0	1.0
1101–2200	30	4.5	1.5
2201–4400	40	6.0	2.0
4401–11,000	60	9.0	3.0
11,001–22,000	80	12.0	4.0
22,001–150,000	100	15.0	5.0

(3) *Testing of pistachios.* Test samples shall be received and logged by an accredited laboratory and each test sample shall be prepared and analyzed using High Pressure Liquid Chromatograph (HPLC) and Vicam Method (Aflatest) or other methods as recommended by not less than seven members of the committee and approved by the Secretary. The aflatoxin level shall be calculated on a kernel weight basis.

(4) *Certification of lots ''negative'' as to aflatoxin.* Lots will be certified as ''negative'' on the aflatoxin inspection certificate if Test Sample #1 has an aflatoxin level at or below 5 ppb. If the aflatoxin level of Test Sample #1 is above 25 ppb, the lot fails and the accredited laboratory shall fill out a failed lot notification report as specified in § 983.40. If the aflatoxin level of Test Sample #1 is above 5 ppb and below 25 ppb, the accredited laboratory may at the handler's discretion analyze Test Sample #2 and the test results of Test Samples #1 and #2 will be averaged. Alternatively, the handler may elect to withdraw the lot from testing, rework the lot, and re-submit it for testing after re-working. If the handler directs the laboratory to proceed with the analysis of Test Sample #2, a lot will be certified as negative to aflatoxin and the laboratory shall issue an aflatoxin inspection certificate if the averaged results of Test Samples #1 and Test Sample #2 is at or below 10 ppb. If the averaged aflatoxin level of the Test Samples #1 and #2 is at or above 20 ppb, the lot fails and the accredited laboratory shall fill out a failed lot notification report as specified in § 983.40. If the averaged aflatoxin level of Test Samples #1 and #2 is above 10 ppb and below 20 ppb, the accredited laboratory may, at the handler's discretion, analyze Test Sample #3 and the results of Test Samples #1, #2 and #3 will be averaged. Alternatively, the handler may elect to withdraw the lot from testing, re-work the lot, and re-submit it for testing after a re-working. If the handler directs the laboratory to proceed with the analysis of Test Sample #3, a lot will be certified as negative to aflatoxin and the laboratory shall issue an aflatoxin inspection certificate if the averaged results of Test Samples #1, #2 and #3 is at or below 15 ppb. If the averaged aflatoxin results of Test Samples #1, #2 and #3 is above 15 ppb, the lot fails and the accredited laboratory shall fill out a failed lot notification report as specified in § 983.40. The accreditation laboratory shall send a copy of the failed lot notification report to the committee and to the failed lot's owner within 10 working days of any failure described in this section. If the lot is certified as negative as described in this section, the aflatoxin inspection certificate shall certify the lot using a certification form identifying each lot by weight, grade and date. The certification expires for the lot or remainder of the lot after 12 months.

(5) *Certification of aflatoxin levels.* Each accredited laboratory shall complete aflatoxin testing and reporting and shall certify that every lot of California pistachios shipped domestically does not exceed the aflatoxin levels as required in § 983.38(d)(4). Each handler shall keep a record of each test, along with a record of final shipping disposition. These records must be maintained for three years beyond the crop year of their applicability, and are subject to audit by the Secretary or the committee at any time.

(6) *Test samples that are not used for analysis.* If a handler does not elect to use Test Samples #2 or #3 for certification purposes the handler may request the laboratory to return them to the handler.

§ 983.39 Minimum quality levels.

(a) *Maximum defect and minimum size.* No handler shall ship for domestic human consumption, pistachios that exceed permissible maximum defect and minimum size levels shown in the following Table 3.

TABLE 3.—MAXIMUM DEFECT AND MINIMUM SIZE LEVELS

Factor	Maximum permissible defects (percent by weight)	
	Inshell	Kernels
External (Shell) Defects		
1. Non-splits & not split on suture	10.0	
(i) Maximum non-splits allowed	4.0	
2. Adhering hull material	2.0	
3. Dark stain	3.0	
4. Damage by other means, other than paragraphs 1, 2 and 3, which materially detracts from the appearance or the edible or marketing quality of the individual shell or the lot	10.0	
Internal (Kernel) Deffects		
1. Damage	6.0	3.0
Immature kernel (Fills <75%–<50% of the shell)		
Kernel spotting (Affects ⅛ aggregate surface)		
2. Serious damage	4.0	2.5
Minor insect or vertebrate injury/insect damage, insect evidence, mold, rancidity, decay		
(i) Maximum insect damage allowed	2.0	0.5
Total external or internal defects allowed	9.0	
Other Defects		
1. Shell pieces and blanks (Fills <50% of the shell)	2.0	
(i) Maximum blanks allowed	1.0	
2. Foreign material	0.25	0.1
No glass, metal or live insects permitted		
3. Particles and dust	0.25	
4. Loose kernels	6.0	
	Minimum permissible defects (percent by weight)	
Maximum allowable inshell pistachios that will pass through a 30/64ths inch round hole screen	5.0	

(b) *Definitions applicable to permissible maximum defect and minimum size levels:* The following definitions shall apply to inshell pistachio and pistachio kernel maximum defect and minimum size:

(1) *Loose kernels* means edible kernels or kernel portions that are out of the shell and which cannot be considered particles and dust.

(2) *External (shell) defects* means any abnormal condition affecting the hard covering around the kernel. Such defects include, but are not limited to, non-split shells, shells not split on suture, adhering hull material or dark stains.

(3) *Damage by external (shell) defects* shall also include any specific defect described in paragraphs (b)(3)(i) through (iv) of this section or an equally objectionable variation of any one of these defects, any other defect or any combination of defects which materially detracts from the appearance or the edibility or the marketing quality of the individual shell or the lot.

(i) *Non-split shells* means shells are not opened or are partially opened and will not allow an 18/1000 (.018) inch thick by ¼ (.25) inch wide gauge to slip into the opening.

(ii) *Not split on suture* means shells are split other than on the suture and will allow an 18/1000 (.018) inch thick by ¼ (.25) inch wide gauge to slip into the opening.

(iii) *Adhering hull material* means an aggregate amount of hull covers more than one-eighth (⅛) of the total shell surface, or when readily noticeable on dyed shells.

(iv) *Dark stain* on raw or roasted nuts means an aggregate amount of dark brown, dark gray or black discoloration that affects more than one-eighth of the total shell surface. Pistachios that are dyed or color-coated to improve their marketing quality are not subject to the maximum permissible defects for dark stain. Speckled discoloration on the stem end, bottom quarter of the nut is not considered damage.

(4) *Internal (kernel) defects* means any damage affecting the kernel. Such damage includes, but is not limited to evidence of insects, immature kernels, rancid kernels, mold or decay.

(i) *Damage by internal (kernel) defects* shall also include any specific defect described in paragraphs (b)(4)(i)(A) and (B) of this section, or an equally objectionable variation of any one of these defects, any other defect, or any combination of defects, which materially detracts from the appearance or the edibility or the marketing quality of the individual kernel or of the lot.

(A) *Immature kernels* in inshell are excessively thin kernels, or when a kernel fills less than three-fourths, but not less than one-half of the shell cavity. ''Immature kernels'' in shelled pistachios are excessively thin kernels and can have black, brown or gray surface with a dark interior color and the immaturity has adversely affected the flavor of the kernel.

(B) *Kernel spotting* refers to dark brown or dark gray spots aggregating more than one-eighth of the surface of the kernel.

(ii) *Serious damage* by internal (kernel) defects means any specific defect described in paragraphs (b)(4)(ii)(A) through (E) of this section, or an equally objectionable variation of any one of these defects, which seriously detracts from the appearance or the edibility or the marketing quality of the individual kernel or of the lot.

(A) *Minor insect or vertebrate injury* means the kernel shows conspicuous evidence of feeding.

(B) *Insect damage* means an insect, insect fragment, web or frass attached to the kernel. No live insects shall be permitted.

(C) *Mold* that is readily visible on the shell or kernel.

(D) Rancidity means the kernel is distinctly rancid to taste. Staleness of flavor shall not be classed as rancidity.

(E) *Decay* means 1/16th or more of the kernel surface is decomposed.

(5) *Other defects* means defects that cannot be considered internal defects or external defects. Such defects include, but are not limited to shell pieces, blanks, foreign materials or particles and dust. The following shall be considered other defects:

(i) *Shell pieces* means open inshell without a kernel, half shells or pieces of shell which are loose in the sample.

(ii) *Blanks* means a non-split shell not containing a kernel or containing a kernel that fills less than one-half of the shell cavity.

(iii) *Foreign material* means leaves, sticks, loose hulls or hull pieces, dirt, rocks, insects or insect fragments not attached to nuts, or any substance other than pistachio shells or kernels. Glass, metal or live insects shall not be permitted.

(iv) *Particles and dust* means pieces of nut kernels that will pass through 5⁄64 inch round opening.

(v) *Undersized* means inshell pistachios that fall through a 30⁄64-inch round hole screen.

(c) *Minimum quality certificate.* Each shipment for domestic human consumption must be covered by a USDA certificate certifying a minimum quality or higher. Pistachios that fail to meet the minimum quality specifications shall be disposed of in such manner as described in § 983.40.

(d) *Transfers between handlers.* Transfers between handlers within the production area are exempt from the minimum quality regulation of this section.

(e) *Minimum quality testing procedures.* To obtain a minimum quality certificate, each lot to be certified shall be uniquely identified, shall be traceable from testing through shipment by the handler and shall be subjected to the following procedure:

(1) *Sampling of pistachios for maximum defects and minimum size.* The gross weight of the inshell and kernel sample, and number of samplings required to meet the minimum quality regulation, is shown in Table 4 of this paragraph (e)(1). These samples shall be drawn from the lot that is to be certified pursuant to § 983.38(d)(1) under the supervision of an inspector or as approved under an alternative USDA recognized inspection program.

TABLE 4.—INSHELL AND KERNEL PISTACHIO LOT SAMPLING INCREMENTS FOR MINIMUM QUALITY CERTIFICATION

Lot weight (lbs.)	Number of incremental samples for the lot sample	Total weight of lot sample (grams)	Weight of inshell and kernel test sample (grams)
220 or less	10	500	500
221–440	15	500	500
441–1100	20	600	500
1101–2200	30	900	500
2201–4400	40	1200	500
4401–11,000	60	1800	500
11,001–22,000	80	2400	1000
22,001–150,000	100	3000	1000

(2) *Testing of pistachios for maximum defect and minimum size.* The sample shall be analyzed according to USDA protocol, current or as subsequently revised, to insure that the lot does not exceed maximum defects and meets at least the minimum size levels as specified in Table 3 of paragraph (a) of this section. For inshell pistachios, those nuts with dark stain, adhering hull, and those exhibiting apparent serious defects shall be shelled for internal kernel analysis. The USDA protocol currently appears in USDA inspection instruction manual ''Pistachios in the Shell, Shipping Point and Market Inspection Instructions,'' June 1994: revised September 1994, HU–125–9(b). Copies may be obtained from the Fresh Products Branch, Agricultural Marketing Service, USDA. Contact information may be found at *http://www.ams.usda.gov/fv/fvstand.htm.*

(f) *Certification of minimum quality.* Each inspector shall complete minimum quality testing and reporting and shall certify that every lot of California pistachios or portion thereof shipped domestically meets minimum quality levels. A record of each test, along with a record of final shipping disposition, shall be kept by each handler. These records must be maintained for three years following the production year in which the pistachios were shipped, and are subject to audit by the committee at any time.

§ 983.40 Failed lots/rework procedure.

(a) *Substandard pistachios.* Each lot of substandard pistachios may be reworked to meet minimum quality requirements.

(b) *Failed lot reporting.* If a lot fails to meet the aflatoxin and/or the minimum quality requirements of this part, a failed lot notification report shall be completed and sent to the committee within 10 working days of the test failure. This form must be completed and submitted to the committee each time a lot fails either aflatoxin or the minimum quality testing. The accredited laboratories shall send the failed lot notification reports for aflatoxin tests to the committee, and the handler, under the supervision of an inspector, shall send the failed lot notification reports for the lots that do not meet the minimum quality requirements to the committee.

(c) *Inshell rework procedure for aflatoxin.* If inshell rework is selected as a remedy to meet the aflatoxin requirements of this part, then 100% of the product within that lot shall be removed from the bulk and/or retail packaging containers and reworked to remove the portion of the lot that caused the failure. Reworking shall consist of mechanical, electronic or manual procedures normally used in the handling of pistachios. After the rework procedure has been completed the total weight of the accepted product and the total weight of the rejected product shall be reported to the committee. The reworked lot shall be sampled and tested for aflatoxin as specified in § 983.38 except that the lot sample size and the test sample size shall be doubled. The reworked lot shall also be sampled and tested for the minimum quality requirements. If, after the lot has been reworked and tested, it fails the aflatoxin test for a second time, the lot may be shelled and the kernels reworked, sampled and tested in the manner specified for an original lot of kernels, or the failed lot may be used for non-human consumption or otherwise disposed of.

(d) *Kernel rework procedure for aflatoxin.* If pistachio kernel rework is selected as a remedy to meet the aflatoxin requirements of § 983.38, then 100% of the product within that lot shall be removed from the bulk and/or retail packaging containers and reworked to remove the portion of the lot that caused the failure. Reworking shall consist of mechanical, electronic or manual procedures normally used in the handling of pistachios. After the rework procedure has been completed the total weight of the accepted product and the total weight of the rejected product shall be reported to the committee. The reworked lot shall be sampled and tested for aflatoxin as specified in § 983.38.

(e) *Minimum quality rework procedure for inshell pistachios and kernels.* If rework is selected as a remedy to meet the minimum quality requirements of § 983.39, then 100% of the product within that lot shall be removed from the bulk and/or retail packaging containers and processed to remove the portion of the lot that caused the failure. Reworking shall consist of mechanical, electronic or manual procedures normally used in the handling of pistachios. The reworked lot shall be sampled and tested for the minimum quality requirements as specified in the minimum quality regulations of § 983.39.

§ 983.41 Testing of minimal quantities.

(a) *Aflatoxin.* Handlers who handle less than 1 million pounds of assessed weight per year, have the option of utilizing both of the following methods for testing for aflatoxin:

(1) The handler may have an inspector sample and test his or her entire inventory of hulled and dried pistachios for the aflatoxin certification before further processing.

(2) The handler may segregate receipts into various lots at the handler's discretion and have an inspector sample and test each specific lot. Any lots that have less than 15 ppb aflatoxin can be certified by an inspector to be negative as to aflatoxin. Any lots that are found to be above 15 ppb may be tested after reworking in the same manner as specified in § 983.38.

(b) *Minimum quality.* Handlers who handle less than 1 million pounds of assessed weight can apply to the committee for an exemption from minimum quality testing. If the committee grants an exemption, then the handler must pull and retain samples of the lots and make samples available for review by the committee. The handler shall maintain the samples for 90 days.

§ 983.42 Commingling.

After a lot is issued an aflatoxin inspection certificate and minimum quality certificate, it may be commingled with other certified lots.

§ 983.43 Reinspection.

The Secretary, upon recommendation of the committee, may establish rules and regulations to establish conditions under which pistachios would be subject to reinspection.

§ 983.44 Inspection, certification and identification.

Upon recommendation of the committee and approval of the Secretary, all pistachios that are required to be inspected and certified in accordance with this part, shall be identified by appropriate seals, stamps, tags, or other identification to be affixed to the containers by the handler. All inspections shall be at the expense of the handler.

§ 983.45 Substandard pistachios.

The committee shall, with the approval of the Secretary, establish such reporting and disposition procedures as it deems necessary to ensure that pistachios which do not meet the outgoing maximum aflatoxin tolerance and minimum quality requirements prescribed by §§ 983.38 and 983.39 shall not be shipped for domestic human consumption.

§ 983.46 Modification or suspension of regulations.

(a) In the event that the committee, at any time, finds that, by reason of changed conditions, the order provisions contained in § 983.38 through § 983.45 should be modified or suspended, it shall by vote of at least seven concurring members, so recommend to the Secretary.

(b) Whenever the Secretary finds from the recommendations and information submitted by the committee or from other available information, that the aflatoxin or minimum quality provisions in § 983.38 and § 983.39 should be modified, suspended, or terminated with respect to any or all shipments of pistachios in order to effectuate the declared policy of the Act, the Secretary shall modify or suspend such provisions. If the Secretary finds that a regulation obstructs or does not tend to effectuate the declared policy of the Act, the Secretary shall suspend or terminate such regulation.

(c) The committee, with the approval of the Secretary, may issue rules and regulations implementing §§ 983.38 through 983.45.

Reports, Books and Records

§ 983.47 Reports.

Upon the request of the committee, with the approval of the Secretary, each handler shall furnish such reports and information on such forms as are needed to enable the Secretary and the committee to perform their functions and enforce the regulations under this part. The committee shall provide a uniform report format for the handlers.

§ 983.48 Confidential information.

All reports and records furnished or submitted by handlers to the committee which include confidential data or information constituting a trade secret or disclosing the trade position, financial condition, or business operations of the particular handler or their customers shall be received by, and at all times kept in the custody and under the control of, one or more employees of the committee, who shall disclose such data and information to no person except the Secretary. However, such data or information may be disclosed only with the approval of the Secretary, to the committee when reasonably necessary to enable the committee to carry out its functions under this part.

§ 983.49 Records.

Records of pistachios received, held and shipped by him, as will substantiate any required reports and will show performance under this part will be maintained by each handler for at least three years beyond the crop year of their applicability.

§ 983.50 Random verification audits.

(a) All handlers' pistachio inventory shall be subject to random verification audits by the committee to ensure compliance with the terms of the order, and regulations adopted pursuant thereto.

(b) Committee staff or agents of the committee, based on information from the industry or knowledge of possible violations, may make buys of handler product in retail locations. If it is determined that violations of the order have occurred as a result of the buys, the matter will be referred to the Secretary for appropriate action.

§ 983.51 Verification of reports.

For the purpose of checking and verifying reports filed by handlers or the operation of handlers under the provisions of this part, the Secretary and the committee, through their duly authorized agents, shall have access to any premises where pistachios and records relating thereto may be held by any handler and at any time during reasonable business hours, shall be permitted to inspect any pistachios so held by such handler and any and all records of such handler with respect to the acquisition, holding, or disposition of all pistachios which may be held or which may have been shipped by him/her.

Expenses and Assessments

§ 983.52 Expenses.

The committee is authorized to incur such expenses as the Secretary finds are reasonable and likely to be incurred by it during each production year for the maintenance and functioning of the committee and for such other purposes as the Secretary may, pursuant to the provisions of this part, determine to be appropriate.

§ 983.53 Assessments.

(a) Each handler who receives pistachios for processing in each production year shall pay the committee on demand, an assessment based on the pro rata share of the expenses authorized by the Secretary for that year attributable to the assessed weight of pistachios received by that handler in that year.

(b) The committee, prior to the beginning of each production year, shall recommend and the Secretary shall set the assessment for the following production year, which shall not exceed one-half of one percent of the average price received by producers in the preceding production year. The committee, with the approval of the Secretary, may revise the assessment if it determines, based on information including crop size and value, that the action is necessary, and if the revision does not exceed the assessment limitation specified in this section and is made prior to the final billing of the assessment.

§ 983.54 Contributions.

The committee may accept voluntary contributions but these shall only be used to pay for committee expenses.

§ 983.55 Delinquent assessments.

Any handler who fails to pay any assessment within the time required by the committee, shall pay to the committee a late payment charge of 10 percent of the amount of the assessment determined to be past due and, in addition, interest on the unpaid balance at the rate of one and one-half percent per month. The late payment and interest charges may be modified by the Secretary upon recommendation of the committee.

§ 983.56 Accounting.

(a) If, at the end of a production year, the assessments collected are in excess of expenses incurred, such excess shall be accounted for in accordance with one of the following:

(1) If such excess is not retained in a reserve, as provided in paragraph (a)(2) of this section, it shall be refunded proportionately to the persons from whom it was collected in accordance with § 983.53: *Provided,* That any sum paid by a person in excess of his/her pro rata share of the expenses during any production year may be applied by the committee at the end of such production year as credit for such person, toward the committee's fiscal operations of the following production year;

(2) The committee, with the approval of the Secretary, may carry over such excess into subsequent production years as a reserve: *Provided,* That funds already in the reserve do not exceed approximately two production years' budgeted expenses. In the event that funds exceed two production years' budgeted expenses, future assessments will be reduced to bring the reserves to an amount that is less than or equal to two production years' budgeted expenses. Such reserve funds may be used:

(i) To defray expenses, during any production year, prior to the time assessment income is sufficient to cover such expenses;

(ii) To cover deficits incurred during any production year when assessment income is less than expenses;

(iii) To defray expenses incurred during any period when any or all provisions of this part are suspended; and

(iv) To cover necessary expenses of liquidation in the event of termination of this part. Upon such termination, any funds not required to defray the necessary expenses of liquidation shall be disposed of in such manner as the Secretary may determine to be appropriate: *Provided,* That to the extent practical, such funds shall be returned pro rata to the persons from whom such funds were collected.

(b) All funds received by the committee pursuant to the provisions of this part shall be used solely for the purpose specified in this part and shall be accounted for in the manner provided in this part. The Secretary may at any time require the committee and its members to account for all receipts and disbursements.

(c) Upon the removal or expiration of the term of office of any member of the committee, such member shall account for all receipts and disbursements for which that member was personally responsible, deliver all committee property and funds in the possession of such member to the committee, and execute such assignments and other instruments as may be necessary or appropriate to vest in the committee full title to all of the committee property, funds, and claims vested in such member pursuant to this part.

§ 983.57 Implementation and amendments.

The Secretary, upon the recommendation of a majority of the committee, may issue rules and regulations implementing or modifying § 983.47 through § 983.56, inclusive.

Miscellaneous Provisions

§ 983.58 Compliance.

Except as provided in this part, no handler shall handle pistachios, the handling of which has been prohibited or otherwise limited by the Secretary in accordance with provisions of this part; and no handler shall handle pistachios except in conformity to the provision of this part.

§ 983.59 Rights of the Secretary.

The members of the committee (including successors or alternates) and any agent or employee appointed or employed by the committee, shall be subject to removal or suspension at the discretion of the Secretary, at any time. Each and every decision, determination, or other act of the committee shall be subject to the continuing right of the Secretary to disapprove of the same at any time, and upon such disapproval, shall be deemed null and void.

§ 983.60 Personal liability.

No member or alternate member of the committee, nor any employee, representative, or agent of the committee shall be held personally responsible to any handler, either individually, or jointly with others, in any way whatsoever, to any person, for errors in judgment, mistakes, or other acts, either of commission or omission, as such member, alternate member, employee, representative, or agent, except for acts of dishonesty, willful misconduct, or gross negligence.

§ 983.61 Separability.

If any provision of this part is declared invalid, or the applicability thereof to any person, circumstance, or thing is held invalid, the validity of the remainder, or the applicability thereof to any other person, circumstance, or thing, shall not be affected thereby.

§ 983.62 Derogation.

Nothing contained in this part is, or shall be construed to be, in derogation or in modification of the rights of the Secretary or of the United States to exercise any powers granted by the Act or otherwise, or, in accordance with such powers, to act in the premises whenever such action is deemed advisable.

§ 983.63 Duration of immunities.

The benefits, privileges, and immunities conferred upon any person by virtue of this part shall cease upon its termination, except with respect to acts done under and during the existence thereof.

§ 983.64 Agents.

The Secretary may, by a designation in writing, name any person, including any officer or employee of the United States Government, or name any service, division or branch in the United States Department of Agriculture, to act as agent or representative of the Secretary in connection with any of the provisions of this part.

§ 983.65 Effective time.

The provisions of this part, as well as any amendments, shall become effective at such time as the Secretary may declare, and shall continue in force until terminated or suspended in one of the ways specified in § 983.66 or § 983.67.

§ 983.66 Suspension or termination.

The Secretary shall terminate or suspend the operation of any or all of the provisions of this part, whenever he/she finds that such provisions do not tend to effectuate the declared policy of the Act.

§ 983.67 Termination.

(a) The Secretary may at any time terminate the provisions of this part.

(b) The Secretary shall terminate or suspend the operations of any or all of the provisions of this part whenever it is found that such provisions do not tend to effectuate the declared policy of the Act.

(c) The Secretary shall terminate the provisions of this part at the end of any fiscal period whenever it is found that such termination is favored by a majority of producers who, during a representative period, have been engaged in the production of pistachios: *Provided,* That such majority has, during such representative period, produced for market more than fifty percent of the volume of such pistachios produced for market, but such termination shall be announced at least 90 days before the end of the current fiscal period.

(d) Within six years of the effective date of this part the Secretary shall conduct a referendum to ascertain whether continuance of this part is favored by producers. Subsequent referenda to ascertain continuance shall be conducted every six years thereafter. The Secretary may terminate the provisions of this part at the end of any fiscal period in which the Secretary has found that continuance of this part is not favored by a two thirds (⅔) majority of voting producers, or a two thirds (⅔) majority of volume represented thereby, who, during a representative period determined by the Secretary, have been engaged in the production for market of pistachios in the production area. Such termination shall be announced on or before the end of the production year.

(e) The provisions of this part shall, in any event, terminate whenever the provisions of the Act authorizing them cease.

§ 983.68 Procedure upon termination.

Upon the termination of this part, the members of the committee then functioning shall continue as joint trustees, for the purpose of liquidating the affairs of the committee. Action by such trustees shall require the concurrence of a majority of said trustees. Such trustees shall continue in such capacity until discharged by the Secretary, and shall account for all receipts and disbursements and deliver all property on hand, together with all books and records of the committee and the joint trustees, to such persons as the Secretary may direct; and shall upon the request of the Secretary, execute such assignments or other instruments necessary or appropriate to vest in such person full title and right to all the funds, properties, and claims vested in the committee or the joint trustees, pursuant to this part. Any person to whom funds, property, or claims have been transferred or delivered by the committee or the joint trustees, pursuant to this section, shall be subject to the same obligations imposed upon the members of said committee and upon said joint trustees.

§ 983.69 Effect of termination or amendment.

Unless otherwise expressly provided by the Secretary, the termination of this part or of any regulation issued pursuant thereto, or the issuance of any amendment to either thereof, shall not:

(a) Affect or waive any right, duty, obligation, or liability which shall have arisen or which may thereafter arise, in connection with any provisions of this part or any regulation issued there under,

(b) Release or extinguish any violation of this part or any regulation issued there under, or

(c) Affect or impair any rights or remedies of the Secretary, or of any other persons, with respect to such violation.

§ 983.70 Exemption.

Any handler may handle pistachios within the production area free of the requirements in §§ 983.38 through 983.45 and 983.53 if such pistachios are handled in quantities not exceeding 1,000 dried pounds during any marketing year. This subpart may be changed as recommended by the committee and approved by the Secretary.

§ 983.71 Relationship with the California Pistachio Commission.

In conducting committee activities and other objectives under this part, the committee may deliberate, consult, cooperate and exchange information with the California Pistachio Commission. Any sharing of information gathered under this subpart shall be kept confidential in accordance with provisions under section 10(i) of the Act.

***§ 983.90 Counterparts.**

Handlers may sign an agreement with the Secretary indicating their support for this marketing order. This agreement may be executed in multiple counterparts by each handler. If more than fifty percent of the handlers, weighted by the volume of pistachios handled during a representative period, enter into such an agreement, then a marketing agreement shall exist for the pistachio marketing order. This marketing agreement shall not alter the terms of this part. Upon the termination of this part, the marketing agreement has no further force or effect.

***§ 983.91 Additional parties.**

After this part becomes effective, any handler may become a party to the marketing agreement if a counterpart is executed by the handler and delivered to the Secretary.

***§ 983.92 Order with marketing agreement.**

Each signatory handler hereby requests the Secretary to issue, pursuant to the Act, an order for regulating the handling of pistachios in the same manner as is provided for in this agreement.

Dated: July 23, 2003.

A. J. Yates,

Administrator, Agricultural Marketing Service.

[FR Doc. 03–19123 Filed 8–1–03; 8:45 am]

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Federal Register

Monday,
August 4, 2003

Part IV

Department of Health and Human Services

Centers for Medicare & Medicaid Services

41 CFR Parts 409, 411, et al.

Medicare Program; Prospective Payment System and Consolidated Billing for Skilled Nursing Facilities—Update; Final Rule

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Centers for Medicare & Medicaid Services

42 CFR Parts 409, 411, 413, 440, 483, 488, and 489

[CMS–1469–F]

RIN 0938–AL90

Medicare Program; Prospective Payment System and Consolidated Billing for Skilled Nursing Facilities—Update

AGENCY: Centers for Medicare & Medicaid Services (CMS), HHS.

ACTION: Final rule.

SUMMARY: This final rule updates the payment rates used under the prospective payment system (PPS) for skilled nursing facilities (SNFs), for fiscal year (FY) 2004. Annual updates to the PPS rates are required by section 1888(e) of the Social Security Act (the Act), as amended by the Medicare, Medicaid, and SCHIP Balanced Budget Refinement Act of 1999 (BBRA), and the Medicare, Medicaid, and SCHIP Benefits Improvement and Protection Act of 2000 (BIPA), relating to Medicare payments and consolidated billing for SNFs.

DATES: *Effective Date:* This regulation becomes effective on October 1, 2003.

FOR FURTHER INFORMATION CONTACT: John Davis, (410) 786–0008 (for information related to the Wage Index, and for information related to swing-bed providers).

Ellen Gay, (410) 786–4528 (for information related to the case-mix classification methodology, and for information related to swing-bed providers).

Sheila Lambowitz, (410) 786–7605 (for information related to the SNF Market Basket Index and forecast error).

Bill Ullman, (410) 786–5667 (for information related to level of care determinations, consolidated billing, and general information).

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To assist readers in referencing sections contained in this document, we are providing the following Table of Contents.

Table of Contents

In addition, because of the many terms to which we refer by abbreviation in this final rule, we are listing these abbreviations and their corresponding terms in alphabetical order below:

AHE Average Hourly Earnings
ARD Assessment Reference Date
BBA Balanced Budget Act of 1997 (Pub. L. 105–33)
BBRA Medicare, Medicaid and SCHIP Balanced Budget Refinement Act of 1999 (Pub. L. 106–113)
BIPA Medicare, Medicaid, and SCHIP Benefits Improvement and Protection Act of 2000 (Pub. L. 106–554)
CAH Critical Access Hospital
CFR Code of Federal Regulations
CMS Centers for Medicare & Medicaid Services
ECEC Employer Cost for Employee Compensation
ECI Employment Cost Index
FI Fiscal Intermediary
FR Federal Register
FY Fiscal Year
GAO General Accounting Office
HCPCS Healthcare Common Procedure Coding System
IFC Interim Final Rule with Comment Period
MDS Minimum Data Set
MedPAC Medicare Payment Advisory Commission
MEDPAR Medicare Provider Analysis and Review File
MSA Metropolitan Statistical Area
NF Nursing Facility
PPI Producer Price Indices
PPS Prospective Payment System
QIO Quality Improvement Organization
RAVEN Resident Assessment Validation Entry
RFA Regulatory Flexibility Act (Pub. L. 96–354)
RIA Regulatory Impact Analysis
RUG Resource Utilization Groups
SCHIP State Children's Health Insurance Program
SNF Skilled Nursing Facility
UMRA Unfunded Mandates Reform Act (Pub. L. 104–4)

I. Background

On May 16, 2003, we published a proposed rule (hereinafter referred to as the ''proposed rule'') in the **Federal Register** (68 FR 26758), setting forth the proposed updates to the payment rates used under the prospective payment system (PPS) for skilled nursing facilities (SNFs), for FY 2004. Annual updates to the PPS rates are required by section 1888(e) of the Social Security Act (the Act), as amended by the Medicare, Medicaid, and SCHIP Balanced Budget Refinement Act of 1999 (Pub. L. 106–113) (the BBRA) and the Medicare, Medicaid, and SCHIP Benefits Improvement and Protection Act of 2000 (Pub. L. 106–554) (the BIPA), relating to Medicare payments and consolidated billing for SNFs. In the proposed rule, we invited public comments on a number of proposed revisions and technical corrections to the associated regulations. Following the publication of that proposed rule, we then published a supplemental proposed rule (hereinafter referred to as the ''supplemental proposed rule'') on June 10, 2003 (68 FR 34768), in which we invited public comments on possibly revising the annual update methodology by establishing an adjustment to account for forecast error. In addition, we also invited comments on ways to ensure that additional payments that could result from such an adjustment would be used to promote quality of care in the SNF setting (including direct care services to residents).

A. Current System for Payment of SNF Services Under Part A of the Medicare Program

Section 4432 of the Balanced Budget Act of 1997 (Pub. L. 105–33) (the BBA) amended section 1888 of the Act to provide for the implementation of a per diem PPS for SNFs, covering all costs (routine, ancillary, and capital-related) of covered SNF services furnished to beneficiaries under Part A of the Medicare program, effective for cost reporting periods beginning on or after July 1, 1998. We are updating the per diem payment rates for SNFs for FY 2004. Major elements of the SNF PPS include:

• *Rates.* Per diem Federal rates were established for urban and rural areas using allowable costs from FY 1995 cost reports. These rates also included an estimate of the cost of services that, before July 1, 1998, were paid under Part B but furnished to Medicare beneficiaries in a SNF during a Part A covered stay. The rates were adjusted annually using a SNF market basket index. Rates were case-mix adjusted using a classification system (Resource Utilization Groups, version III (RUG–III)) based on beneficiary assessments (using the Minimum Data Set (MDS) 2.0). The rates were also adjusted by the hospital wage index to account for geographic variation in wages. (In section III.C of this final rule, we discuss the wage index adjustment in detail.) A correction notice was published on December 27, 2002 (67 FR 79123) that announced corrections to several of the wage factors. Additionally, as noted in the July 31, 2002 update notice (67 FR 49798), section 101 of the BBRA and certain sections of the BIPA also affect the payment rate.

• *Transition.* The SNF PPS included an initial 3-year, phased transition that blended a facility-specific payment rate with the Federal case-mix adjusted rate. For each cost reporting period after a facility migrated to the new system, the facility-specific portion of the blend decreased and the Federal portion increased in 25 percentage point increments. For most facilities, the facility-specific rate was based on allowable costs from FY 1995; however, since the last year of the transition was FY 2001, all facilities were paid at the full Federal rate by the following fiscal year (FY 2002). Therefore, we are no longer including adjustment factors related to facility-specific rates for the coming fiscal year.

• *Coverage.* The establishment of the SNF PPS did not change Medicare's fundamental requirements for SNF coverage. However, because the RUG–III classification is based, in part, on the beneficiary's need for skilled nursing care and therapy, we have attempted, where possible, to coordinate claims review procedures involving level of care determinations with the outputs of beneficiary assessment and RUG–III classifying activities. We discuss this coordination in greater detail in section III.E of this final rule. Another SNF benefit requirement is that the SNF must be certified by Medicare as meeting the requirements for program participation contained in section 1819 of the Act. This provision of the law defines a SNF as ''* * * an institution (or a distinct part of an institution). * * *'' In section III.K of this final rule, we discuss a clarification that we are making in defining the term ''distinct part'' with respect to SNFs.

• *Consolidated Billing.* The SNF PPS includes a consolidated billing provision that requires a SNF to submit consolidated Medicare bills for almost all of the services that the resident receives during the course of a covered Part A stay. (In addition, this provision places with the SNF the Medicare billing responsibility for physical, occupational, and speech-language therapy that the resident receives during a noncovered stay.) The statute excludes from the consolidated billing provision a few services—primarily those of physicians and certain other types of practitioners—which remain separately billable to Part B by the outside entity that furnishes them. We discuss this provision in greater detail in section III.I of this final rule.

• *Application of the SNF PPS to SNF services furnished by swing-bed hospitals.* Section 1883 of the Act permits certain small, rural hospitals to enter into a Medicare swing-bed agreement, under which the hospital can use its beds to provide either acute or SNF care, as needed. For critical access hospitals (CAHs), Part A pays on a reasonable cost basis for SNF services furnished under a swing-bed agreement. However, in accordance with section 1888(e)(7) of the Act, these services furnished by non-CAH rural hospitals are paid under the SNF PPS, effective with cost reporting periods beginning on or after July 1, 2002. A more detailed discussion of this provision appears in section III.J of this final rule.

• *Technical corrections.* We are also taking this opportunity to make a number of technical corrections in the text of the regulations, as discussed in greater detail in section IV of this final rule.

B. Requirements of the Balanced Budget Act of 1997 (the BBA) for Updating the SNF PPS

Section 1888(e)(4)(H) of the Act requires that we publish in the **Federal Register:**

1. The unadjusted Federal per diem rates to be applied to days of covered SNF services furnished during the fiscal year.
2. The case-mix classification system to be applied with respect to these services during the fiscal year.
3. The factors to be applied in making the area wage adjustment with respect to these services.

In the July 30, 1999 final rule (64 FR 41670), we indicated that we would announce any changes to the guidelines for Medicare level of care determinations related to modifications in the RUG–III classification structure (*see* section III.E of this final rule).

C. The Medicare, Medicaid, and SCHIP Balanced Budget Refinement Act of 1999 (the BBRA)

There were several provisions in the BBRA that resulted in adjustments to the SNF PPS. These provisions were described in detail in the final rule that we published in the **Federal Register** on July 31, 2000 (65 FR 46770). In particular, section 101 of the BBRA provided for a temporary 20 percent increase in the per diem adjusted payment rates for 15 specified RUG–III groups (SE3, SE2, SE1, SSC, SSB, SSA, CC2, CC1, CB2, CB1, CA2, CA1, RHC, RMC, and RMB). Under the statute, this temporary increase remains in effect until the later of October 1, 2000, or the implementation of case-mix refinements in the PPS. Section 101 also included a 4 percent across-the-board increase in the adjusted Federal per diem payment rates each year for FYs 2001 and 2002, exclusive of the 20 percent increase. Accordingly, this 4 percent temporary increase has now expired.

We included further information on all of the provisions of the BBRA that affect the SNF PPS in Program Memoranda A–99–53 and A–99–61 (December 1999), and Program Memorandum AB–00–18 (March 2000). In addition, for swing-bed hospitals with more than 49 (but less than 100) beds, section 408 of the BBRA provided for the repeal of certain statutory restrictions on length of stay and aggregate payment for patient days, effective with the end of the SNF PPS transition period described in section 1888(e)(2)(E) of the Act. In the July 31, 2001 final rule (66 FR 39562), we made conforming changes to the regulations in § 413.114(d), effective for services furnished in cost reporting periods beginning on or after July 1, 2002 to reflect section 408 of the BBRA.

D. The Medicare, Medicaid, and SCHIP Benefits Improvement and Protection Act of 2000 (the BIPA)

The BIPA included several provisions that resulted in adjustments to the PPS for SNFs. These provisions were described in detail in the final rule that we published in the **Federal Register** on July 31, 2001 (66 FR 39562) as follows:

- Section 203 of the BIPA exempted critical access hospital (CAH) swing-beds from the SNF PPS; we included further information on this provision in Program Memorandum A–01–09 (January 16, 2001).
- Section 311 of the BIPA eliminated the one percent reduction in the SNF market basket that the statutory update formula had previously specified for FY 2001, and changed the one percent reduction specified for FYs 2002 and 2003 to a 0.5 percent reduction. This section also required us to conduct a study of alternative case-mix classification systems for the SNF PPS, and to submit a report to the Congress by January 1, 2005.
- Section 312 of the BIPA provided for a temporary 16.66 percent increase in the nursing component of the case-mix adjusted Federal rate for services furnished on or after April 1, 2001, and before October 1, 2002. Accordingly, this temporary increase has now expired.
- Section 313 of the BIPA repealed the consolidated billing requirement for services (other than physical, occupational, and speech-language therapy) furnished to SNF residents during noncovered stays, effective January 1, 2001. This provision also specified that consolidated billing applies only to services furnished to those individuals residing in an institution (or portion of an institution) that is actually certified by Medicare as a SNF.
- Section 314 of the BIPA adjusted the payment rates for all of the rehabilitation RUGs to correct an anomaly under which the existing payment rates for the RHC, RMC, and RMB rehabilitation groups were higher than the rates for some other, more intensive rehabilitation RUGs.
- Section 315 of the BIPA authorized us to establish a geographic reclassification procedure that is specific to SNFs, but only after collecting the data necessary to establish a SNF wage index that is based on wage data from nursing homes.

We included further information on several of these provisions in Program Memorandum A–01–08 (January 16, 2001).

E. General Overview of the SNF PPS

We implemented the Medicare SNF PPS for cost reporting periods beginning on or after July 1, 1998. Under the PPS, we pay SNFs through prospective, case-mix adjusted per diem payment rates applicable to all covered SNF services. These payment rates cover all the costs of furnishing covered skilled nursing services (routine, ancillary, and capital-related costs) other than costs associated with approved educational activities. Covered SNF services include post-hospital services for which benefits are provided under Part A and all items and services that, before July 1, 1998, had been paid under Part B (other than physician and certain other services specifically excluded under the BBA) but furnished to Medicare beneficiaries in a SNF during a covered Part A stay. A complete discussion of these provisions appears in the May 12, 1998 interim final rule (63 FR 26252).

1. Payment Provisions—Federal Rate

The PPS uses per diem Federal payment rates based on mean SNF costs in a base year updated for inflation to the first effective period of the PPS. We developed the Federal payment rates using allowable costs from hospital-based and freestanding SNF cost reports for reporting periods beginning in FY 1995. The data used in developing the Federal rates also incorporated an estimate of the amounts that would be payable under Part B for covered SNF services furnished to individuals during the course of a covered Part A stay in a SNF.

In developing the rates for the initial period, we updated costs to the first effective year of PPS (the 15-month period beginning July 1, 1998) using a SNF market basket, and then standardized for the costs of facility differences in case-mix and for geographic variations in wages. The database used to compute the Federal payment rates excluded providers that received new provider exemptions from the routine cost limits, as well as costs related to payments for exceptions to the routine cost limits. In accordance with the formula prescribed in the BBA, we set the Federal rates at a level equal to the weighted mean of freestanding costs plus 50 percent of the difference between the freestanding mean and weighted mean of all SNF costs (hospital-based and freestanding) combined. We computed and applied separately the payment rates for facilities located in urban and rural areas. In addition, we adjusted the portion of the Federal rate attributable to wage-related costs by a wage index.

The Federal rate also incorporates adjustments to account for facility case-mix, using a classification system that accounts for the relative resource utilization of different patient types. This classification system, Resource Utilization Groups, version III (RUG-III), uses beneficiary assessment data from the Minimum Data Set (MDS) completed by SNFs to assign beneficiaries to one of 44 RUG-III groups. The May 12, 1998 interim final rule (63 FR 26252) included a complete and detailed description of the RUG-III classification system, and a further discussion appears in section III.B of this final rule.

The Federal rates in this final rule reflect an update to the rates that we published in the July 31, 2002 **Federal Register** (67 FR 49798) equal to the full change in the SNF market basket index. According to section 1888(e)(4)(E)(ii)(IV) of the Act, for FY 2004, we have adjusted the current rates by the full SNF market basket index. In addition, the FY 2004 rates will be adjusted by an additional 3.26 percent to reflect the cumulative forecast error since the start of the SNF PPS on July 1, 1998.

2. Payment Provisions—Initial Transition Period

The SNF PPS included an initial, phased transition from a facility-specific rate (which reflected the individual facility's historical cost experience) to the Federal case-mix adjusted rate. The transition extended through the facility's first three cost reporting periods under the PPS, up to, and potentially including, the one that began in FY 2001. Furthermore, according to section 102 of BBRA, a facility could nonetheless elect to be paid entirely under the Federal rates. Accordingly, starting with cost reporting periods beginning in FY 2002, we base payments entirely on the Federal rates and, as mentioned previously in this final rule, we no longer include adjustment factors related to facility-specific rates for the coming fiscal year.

F. Use of the SNF Market Basket Index

Section 1888(e)(5) of the Act requires us to establish a SNF market basket index that reflects changes over time in the prices of an appropriate mix of goods and services included in the covered SNF services. The SNF market basket index is used to update the Federal rates on an annual basis, and is discussed in greater detail in section III.H of this final rule.

II. Provisions of the Proposed Rule and the Supplemental Proposed Rule

The proposed rule that we published in the **Federal Register** on May 16, 2003 (68 FR 26758) included proposed FY 2004 updates to the Federal payment rates used under the SNF PPS. In accordance with section 1888(e)(4)(E)(ii)(IV) of the Act, the updates reflect the full SNF market basket percentage change for the fiscal year. The proposed rule also proposed introducing a one-year lag in the wage index data, similar to the PPS methodologies already being used for home health and inpatient rehabilitation facility services. This one-year lag would avoid the problems associated with multiple mid-year corrections in the hospital wage data. We also proposed clarifying the distinct part criteria to be used, in part, to help identify those SNFs that are hospital-based rather than freestanding. Further, we invited public comments on additional HCPCS codes that could represent the type of ''high-cost, low probability'' services within certain service categories (that is, chemotherapy and its administration, radioisotope services, and customized prosthetic devices) that section 103 of the BBRA has authorized us to exclude from the SNF consolidated billing provision.

In addition to discussing these general issues in the proposed rule, we also proposed making the following specific revisions to the existing text of the regulations:

- In § 409.20, we would make a technical correction to the cross-reference in paragraph (c).
- We would revise § 483.5 to include specific definitions of the terms ''distinct part'' and ''composite distinct part.'' This revision would also involve making conforming changes elsewhere in subpart B of part 483 of the regulations, as well as in parts 413 and 440. In addition, we proposed correcting a typographical error that currently appears in the regulations text at § 483.20(k)(1).

In the supplemental proposed rule that we published in the **Federal Register** on June 10, 2003 (68 FR 34768), we invited public comments on the advisability of amending the regulations text at § 413.337(d)(2), to include an adjustment to the annual update of the previous fiscal year's rate that would account for forecast error in the SNF market basket, beginning with FY 2004. In addition, we also invited comments on methods for ensuring that additional payments that could result from that adjustment would be used to promote quality of care in the SNF setting (including direct care services to residents). We also proposed to make a technical correction to the second sentence of the regulations text in § 413.345, in order to correct the spelling of the word ''standardized.''

More detailed information on each of these issues, to the extent that we received public comments on them, appears in the discussion contained in the following section of this preamble.

III. Analysis of and Responses to Public Comments

In response to the publication of the proposed rule on May 16, 2003 (68 FR 26758) and the supplemental proposed rule on June 10, 2003 (68 FR 34768), we received over 400 comments. Many consisted of form letters, in which we received multiple copies of an identically worded letter that had been signed and submitted by different individuals. Further, we received numerous comments from various trade associations and major organizations. Comments originated from nursing homes, hospitals, and other providers, suppliers, and practitioners, nursing home resident advocacy groups, health care consulting firms and private citizens. The following discussion, arranged by subject area, includes a description of the comments that we received, along with our responses.

Comment: A few commenters expressed concern about the abbreviated comment periods available for the proposed rule and the supplemental proposed rule. They asserted that the shorter timeframes were burdensome, and affected their ability to furnish comprehensive responses. They asked us to provide the full 60-day comment period in the future.

Response: While the proposed rule was not actually published until May 16, 2003, we note that this document went on public display at the Office of the Federal Register several days earlier, on May 10, 2003. Accordingly, the contents of the proposed rule were, in fact, publicly available for the full 60-day comment period. Further, we note that in contrast to the proposed rule, the supplemental proposed rule did not attempt to address the SNF PPS in a comprehensive manner, but instead focused exclusively on a single issue—the possibility of introducing an adjustment to account for forecast error. As noted in the preamble to the supplemental proposed rule (68 FR 34772), given the extremely narrow scope of this document, we believe that even a comment period of less than 60 days provided interested parties with sufficient opportunity to comment adequately on it.

A. Update of Federal Payment Rates Under the SNF PPS

This final rule sets forth a schedule of Federal prospective payment rates applicable to Medicare Part A SNF services beginning October 1, 2003. The schedule incorporates per diem Federal rates that provide Part A payment for all costs of services furnished to a beneficiary in a SNF during a Medicare-covered stay.

1. Costs and Services Covered by the Federal Rates

The Federal rates apply to all costs (routine, ancillary, and capital-related costs) of covered SNF services other than costs associated with approved educational activities as defined in § 413.85. Under section 1888(e)(2) of the Act, covered SNF services include post-hospital SNF services for which benefits are provided under Part A (the hospital insurance program), as well as all items and services (other than those services excluded by statute) that, before July 1, 1998, were paid under Part B (the supplementary medical insurance program) but furnished to Medicare beneficiaries in a SNF during a Part A covered stay. (These excluded service categories are discussed in greater detail in section V.B.2 of the May 12, 1998 interim final rule (63 FR 26295 through 26297)).

2. Methodology Used for the Calculation of the Federal Rates

The FY 2004 rates reflect an update using the full amount of the latest market basket index. The FY 2004 market basket increase factor is 3.0

percent. A complete description of the multi-step process is delineated in the May 12, 1998 interim final rule (63 FR 26252). We note that in accordance with section 101(a) of the BBRA and section 314 of the BIPA, the existing, temporary increase in the per diem adjusted payment rates of 20 percent for certain specified RUGs (and 6.7 percent for certain others) remains in effect until the implementation of case-mix refinements. As we discuss elsewhere in this final rule, while we are proceeding with our ongoing research in this area, we are not implementing case-mix refinements in this final rule.

We used the SNF market basket to adjust each per diem component of the Federal rates forward to reflect cost increases occurring between the midpoint of the Federal fiscal year beginning October 1, 2002, and ending September 30, 2003, and the midpoint of the Federal fiscal year beginning October 1, 2003, and ending September 30, 2004, to which the payment rates apply. In accordance with section 1888(e)(4)(E)(ii)(IV) of the Act, the payment rates for FY 2004 are updated by a factor equal to the full market basket index percentage increase to determine the payment rates for FY 2004. In addition, the FY 2004 rates will be adjusted by an additional 3.26 percent to reflect the cumulative forecast error since the start of the SNF PPS on July 1, 1998. The rates are further adjusted by a wage index budget neutrality factor, described later in this section. Tables 1 and 2 reflect the updated components of the unadjusted Federal rates for FY 2004.

TABLE 1.—FY 2004 UNADJUSTED FEDERAL RATE PER DIEM URBAN

Rate component	Nursing—case-mix	Therapy—case-mix	Therapy—non-case-mix	Non-case-mix
Per Diem Amount	$129.96	$97.89	$12.89	$66.32

TABLE 2.—FY 2004 UNADJUSTED FEDERAL RATE PER DIEM RURAL

Rate component	Nursing—case-mix	Therapy—case-mix	Therapy—non-case-mix	Non-case-mix
Per Diem Amount	$124.16	$112.89	$13.77	$67.55

B. Case-Mix Adjustment

Under the BBA, we must publish the SNF PPS case-mix classification methodology applicable for the next Federal fiscal year before August 1 of each year. As noted in the following discussion, we are proceeding with our ongoing research regarding possible refinements in the existing case-mix classification system, but we are not implementing the refinements in this final rule.

As discussed previously in this final rule, section 101(a) of the BBRA provided for a temporary 20 percent increase in the per diem adjusted payment rates for 15 specified RUG–III groups. This legislation specified that the 20 percent increase would be effective for SNF services furnished on or after April 1, 2000, and would continue until the later of: (1) October 1, 2000, or (2) implementation of a refined case-mix classification system under section 1888(e)(4)(G)(i) of the Act that would better account for medically complex patients.

In the SNF PPS proposed rule for FY 2001 (65 FR 19190, April 10, 2000), we proposed making an extensive, comprehensive set of refinements to the existing case-mix classification system that collectively would have significantly expanded the existing 44-group structure. However, when our subsequent validation analyses indicated that the refinements would afford only a limited degree of improvement in explaining resource utilization relative to the significant increase in complexity that they would entail, we decided not to implement them at that time (see the FY 2001 final rule published July 31, 2000 (65 FR 46773)). Nevertheless, since the BBRA provision had demonstrated a Congressional interest in improving the ability of the payment system to account for the care furnished to medically complex patients in SNFs, we continued to conduct research in this area.

The Congress subsequently enacted section 311(e) of the BIPA, which directed us to conduct a study of the different systems for categorizing patients in Medicare SNFs in a manner that accounts for the relative resource utilization of different patient types, and to issue a report with any appropriate recommendations to the Congress by January 1, 2005. The extended timeframe for conducting the study, and the broad mandate in the BIPA to consider various classification systems and the full range of patient types, stood in sharp contrast to the BBRA language regarding more incremental refinements to the existing case-mix classification system under section 1888(e)(4)(G)(i) of the Act. This underscored the fact that implementing the latter type of refinements to the existing system in order to better account for medically complex patients need not await the completion of the more comprehensive changes envisioned in the BIPA. Accordingly, we considered the possibility of including these refinements as part of last year's annual update of the SNF payment rates.

However, in the July 31, 2002 update notice (67 FR 49801), we determined that the research was not sufficiently advanced to implement any case-mix refinements at that time, thus leaving the current classification system in place. This also left in place the temporary add-on payments enacted in section 101(a) of the BBRA. Further, while we have continued with our ongoing research regarding possible refinements in the existing case-mix classification system, this research has not yet provided the basis for proceeding with those refinements. Accordingly, we are not implementing case-mix refinements in this final rule.

As a result, the payment rates set forth in this final rule reflect the continued use of the 44-group RUG–III classification system discussed in the May 12, 1998 interim final rule (63 FR 26252). We are also maintaining the add-ons to the Federal rates for the specified RUG–III groups required by section 101(a) of the BBRA and subsequently modified by section 314 of the BIPA. The case-mix adjusted payment rates are listed separately for urban and rural SNFs in Tables 3 and 4, with the corresponding case-mix values. These tables do not reflect the temporary add-on to the specified RUG–III groups provided in the BBRA, which is applied only after all other adjustments (wage and case-mix) have been made.

Meanwhile, we are continuing to explore both short-term and longer-range revisions to our case-mix classification methodology. In July 2001, we awarded a contract to the Urban Institute for research to aid us in making incremental refinements to the case-mix classification system under section 1888(e)(4)(G)(i) of the Act and to begin the case-mix study mandated by section 311(e) of the BIPA. The results of our current research will be included in the report to the Congress that section 311(e) of the BIPA requires us to submit by January 1, 2005. As we noted in the May 10, 2001 proposed rule (66 FR 23990), this research may also support a longer term goal of developing more integrated approaches for the payment and delivery system for Medicare post acute services in general. This broader, ongoing research project will pursue several avenues in studying various case-mix classification systems. Our preliminary research has focused on incorporating comorbidities and complications into the classification strategy, and we will thoroughly explore and evaluate this approach and other approaches (including procedures that might account more accurately for ancillary services) in our ongoing work.

Comment: Several commenters commended our decision not to implement case-mix refinements in FY 2004. They expressed the belief that incremental refinements may only represent ''patches'' on a system that needs a more comprehensive redesign, and could destabilize an already vulnerable health care industry. Other commenters urged us to move quickly to identify and implement short-term incremental improvements to provide more appropriate reimbursement for patients with heavy non-therapy ancillary needs.

Response: As discussed in the proposed rule, we continue to explore both short-term case-mix refinements and longer-range redesign of the SNF PPS methodology. Our primary goal is to enhance the accuracy of our reimbursement system by more closely matching payment with resource utilization, particularly in the utilization of non-therapy ancillaries. We have made this issue a research priority to ensure continued access to quality care for this very vulnerable heavy care population. However, we are cautious about premature implementation of any policy that has not been thoroughly analyzed to allocate payment dollars more accurately. Therefore, we have decided not to implement case-mix refinements for FY 2004. However, we are proceeding with our research and plan to evaluate the feasibility of implementing refinements again next year.

Comment: Several commenters agreed with the need for short-term action to stabilize the SNF PPS and suggested some alternative methodologies for achieving these goals, including more frequent updating of the SNF market basket and the development of an outlier pool that could address beneficiaries with heavy non-therapy ancillary needs. A few commenters suggested addressing the non-therapy ancillary needs by seeking a legislative change to redirect the 6.7 percent add-on payments for the 14 RUG–III therapy groups to those RUG–III groups used for beneficiaries with complex medical conditions and high utilization of non-therapy ancillary services.

Response: Each of the suggestions discussed above would require statutory authority that does not currently exist. However, we will carefully consider the comments that we received and use these comments to assist us in exploring potential solutions. While we will continue to focus on the needs of those beneficiaries who require an unusually heavy combination of clinical care, rehabilitation services, and ancillary utilization, we will also continue to consider a broad range of potential changes. We expect to discuss our research findings by January 1, 2005, in the report to the Congress that is required under section 311(e) of the BIPA.

Comment: Most of the commenters supported the continuation of our long-term research efforts designed to identify possible alternatives to the existing SNF PPS. Many commenters suggested expanding communications with providers and other interest groups in a manner similar to the approach that we have adopted for Open Door meetings. Most commenters recommended that we also enhance communications by sharing our research findings, and by including a detailed analysis in the 2005 report to the Congress.

Response: We appreciate the interest shown by providers and other stakeholders in our continuing research. We plan to consider all of the comments that we have received regarding potential changes to the classification system, as well as to other components of the SNF PPS, as we continue our analysis and prepare the required report to the Congress. As we pursue our research effort and evaluate our options, we will seek appropriate means to establish ongoing communication with, and input from, all stakeholder groups.

Comment: Most commenters urged us to minimize provider burden by providing adequate lead time for comment and for implementation of any significant changes. One commenter also suggested that we improve our coordination of related projects such as the Minimum Data Set (MDS) 3.0 implementation and the SNF PPS redesign, so that providers can incorporate changes smoothly and provide necessary staff training with minimal disruption to staff and patients.

Response: We recognize the inherent difficulties in coordinating potential changes to the MDS with potential changes to the SNF PPS. In fact, our staff in the payment, quality monitoring, and survey and certification areas have addressed this issue by establishing an in-house work group to share information and coordinate activities. By working together, we believe that we enhance our effectiveness and can introduce changes with minimal disruption and burden to providers. In addition, the introduction of the MDS 3.0 and any case-mix refinement changes to the SNF PPS would be accomplished through established administrative processes that will solicit stakeholder input. Finally, we fully agree that providers and other stakeholders will need adequate lead time to implement significant policy and operational changes.

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Table 3
CASE-MIX ADJUSTED FEDERAL RATES AND ASSOCIATED INDICES
URBAN

RUG-III Category	Nursing Index	Therapy Index	Nursing Component	Therapy Component	Non-case Mix Therapy Comp	Non-case Mix Component	Total Rate
RUC	1.30	2.25	168.95	220.25		66.32	455.52
RUB	0.95	2.25	123.46	220.25		66.32	410.03
RUA	0.78	2.25	101.37	220.25		66.32	387.94
RVC	1.13	1.41	146.85	138.02		66.32	351.19
RVB	1.04	1.41	135.16	138.02		66.32	339.50
RVA	0.81	1.41	105.27	138.02		66.32	309.61
RHC	1.26	0.94	163.75	92.02		66.32	322.09
RHB	1.06	0.94	137.76	92.02		66.32	296.10
RHA	0.87	0.94	113.07	92.02		66.32	271.41
RMC	1.35	0.77	175.45	75.38		66.32	317.15
RMB	1.09	0.77	141.66	75.38		66.32	283.36
RMA	0.96	0.77	124.76	75.38		66.32	266.46
RLB	1.11	0.43	144.26	42.09		66.32	252.67
RLA	0.80	0.43	103.97	42.09		66.32	212.38
SE3	1.70		220.93		12.89	66.32	300.14
SE2	1.39		180.64		12.89	66.32	259.85
SE1	1.17		152.05		12.89	66.32	231.26
SSC	1.13		146.85		12.89	66.32	226.06
SSB	1.05		136.46		12.89	66.32	215.67
SSA	1.01		131.26		12.89	66.32	210.47
CC2	1.12		145.56		12.89	66.32	224.77
CC1	0.99		128.66		12.89	66.32	207.87
CB2	0.91		118.26		12.89	66.32	197.47
CB1	0.84		109.17		12.89	66.32	188.38
CA2	0.83		107.87		12.89	66.32	187.08
CA1	0.75		97.47		12.89	66.32	176.68
IB2	0.69		89.67		12.89	66.32	168.88
IB1	0.67		87.07		12.89	66.32	166.28
IA2	0.57		74.08		12.89	66.32	153.29
IA1	0.53		68.88		12.89	66.32	148.09
BB2	0.68		88.37		12.89	66.32	167.58

BB1	0.65		84.47		12.89	66.32	163.68
BA2	0.56		72.78		12.89	66.32	151.99
BA1	0.48		62.38		12.89	66.32	141.59
PE2	0.79		102.67		12.89	66.32	181.88
PE1	0.77		100.07		12.89	66.32	179.28
PD2	0.72		93.57		12.89	66.32	172.78
PD1	0.70		90.97		12.89	66.32	170.18
PC2	0.65		84.47		12.89	66.32	163.68
PC1	0.64		83.17		12.89	66.32	162.38
PB2	0.51		66.28		12.89	66.32	145.49
PB1	0.50		64.98		12.89	66.32	144.19
PA2	0.49		63.68		12.89	66.32	142.89
PA1	0.46		59.78		12.89	66.32	138.99

Table 4
CASE-MIX ADJUSTED FEDERAL RATES AND ASSOCIATED INDICES
RURAL

RUG-III Category	Nursing Index	Therapy Index	Nursing Component	Therapy Component	Non-case Mix Therapy Comp	Non-case Mix Component	Total Rate
RUC	1.30	2.25	161.41	254.00		67.55	482.96
RUB	0.95	2.25	117.95	254.00		67.55	439.50
RUA	0.78	2.25	96.84	254.00		67.55	418.39
RVC	1.13	1.41	140.30	159.17		67.55	367.02
RVB	1.04	1.41	129.13	159.17		67.55	355.85
RVA	0.81	1.41	100.57	159.17		67.55	327.29
RHC	1.26	0.94	156.44	106.12		67.55	330.11
RHB	1.06	0.94	131.61	106.12		67.55	305.28
RHA	0.87	0.94	108.02	106.12		67.55	281.69
RMC	1.35	0.77	167.62	86.93		67.55	322.10
RMB	1.09	0.77	135.33	86.93		67.55	289.81
RMA	0.96	0.77	119.19	86.93		67.55	273.67
RLB	1.11	0.43	137.82	48.54		67.55	253.91
RLA	0.80	0.43	99.33	48.54		67.55	215.42
SE3	1.70		211.07		13.77	67.55	292.39
SE2	1.39		172.58		13.77	67.55	253.90
SE1	1.17		145.27		13.77	67.55	226.59
SSC	1.13		140.30		13.77	67.55	221.62
SSB	1.05		130.37		13.77	67.55	211.69
SSA	1.01		125.40		13.77	67.55	206.72
CC2	1.12		139.06		13.77	67.55	220.38
CC1	0.99		122.92		13.77	67.55	204.24
CB2	0.91		112.99		13.77	67.55	194.31
CB1	0.84		104.29		13.77	67.55	185.61
CA2	0.83		103.05		13.77	67.55	184.37
CA1	0.75		93.12		13.77	67.55	174.44
IB2	0.69		85.67		13.77	67.55	166.99
IB1	0.67		83.19		13.77	67.55	164.51
IA2	0.57		70.77		13.77	67.55	152.09
IA1	0.53		65.80		13.77	67.55	147.12
BB2	0.68		84.43		13.77	67.55	165.75
BB1	0.65		80.70		13.77	67.55	162.02

BA2	0.56		69.53		13.77	67.55	150.85
BA1	0.48		59.60		13.77	67.55	140.92
PE2	0.79		98.09		13.77	67.55	179.41
PE1	0.77		95.60		13.77	67.55	176.92
PD2	0.72		89.40		13.77	67.55	170.72
PD1	0.70		86.91		13.77	67.55	168.23
PC2	0.65		80.70		13.77	67.55	162.02
PC1	0.64		79.46		13.77	67.55	160.78
PB2	0.51		63.32		13.77	67.55	144.64
PB1	0.50		62.08		13.77	67.55	143.40
PA2	0.49		60.84		13.77	67.55	142.16
PA1	0.46		57.11		13.77	67.55	138.43

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C. Wage Index Adjustment to Federal Rates

Section 1888(e)(4)(G)(ii) of the Act requires that we adjust the Federal rates to account for differences in area wage levels, using a wage index that we find appropriate. Since the inception of a PPS for SNFs, we have used hospital wage data in developing a wage index to be applied to SNFs. We are continuing that practice for FY 2004.

Section 315 of the BIPA authorizes us to establish a reclassification system for SNFs, similar to the hospital methodology. This geographic reclassification system cannot be implemented until we have collected the data necessary to establish an area wage index for SNFs based on SNF wage data. We presented a comprehensive discussion of this wage data in the May 10, 2001 proposed rule (66 FR 23984) and the July 31, 2001 final rule (66 FR 39562).

1. Selecting the Most Appropriate Wage Index

In the May 10, 2001 proposed rule, we published a wage index prototype based on SNF data, along with the wage index based on the hospital wage data that were used in the preceding year's final rule (July 31, 2000, 65 FR 46770). In addition, we included a discussion of the wage index computations for the SNF prototype. We also indicated our concern about the reliability of the existing data used in establishing a SNF wage index, in view of the significant variations in the SNF-specific wage data and the large number of SNFs that are unable to provide adequate wage and hourly data. Accordingly, we expressed the belief that a wage index based on hospital wage data remains the best and most appropriate to use in adjusting payments to SNFs, since both hospitals and SNFs compete in the same labor markets.

In the July 31, 2001 final rule (66 FR 39579), we indicated that we had decided not to adopt the SNF-specific wage index prototype from the proposed rule, citing concerns such as the significant amount of volatility in the data. In addition, while we acknowledged that auditing all SNFs would provide more accurate and reliable data, we observed that this would place a burden on providers in terms of recordkeeping and completion of the cost report worksheet. We also noted that adopting such an approach would require a significant commitment of resources by us and by our contractors.

As we noted in the May 16, 2003 proposed rule (68 FR 26767), while we continue to believe that the development of a SNF-specific wage index potentially could improve the accuracy of SNF payments, we do not regard an undertaking of this magnitude as being feasible within the current level of programmatic resources. However, we remain willing to consider the adoption of a SNF-specific wage index should sufficient staffing and budgetary resources to support it become available in the future.

In the May 16, 2003 rule, we proposed continuing to use the final FY 2003 hospital wage index to adjust SNF PPS payments beginning October 1, 2003. Then, for future rate years, we proposed continuing to use the most recently published wage index values (that is, the final FY 2003 wage index data) final wage index values rather than following our current practice of using the most recent available data. The impact of this change would have been to establish a one-year lag between the wage index values used in the hospital PPS (that is, FY 2004 wage index) and the data used in the SNF PPS. As explained in our responses to the comments shown later in this section, we have decided not to implement this one-year lag. Therefore, the wage index values in Tables 7 and 8 reflect the most recent available data; that is, the same FY 2004 wage data that will be used for the FY 2004 inpatient hospital PPS rates.

Comment: A substantial number of commenters expressed concern about the appropriateness of using the most recently published wage index values to adjust the payments for SNFs, when more recent data are available. Many asked that we use the more recent data, even if they are more vulnerable to errors requiring mid-year correction. They pointed out that the most recently published wage index values are already several years old, since the data have to be reviewed and audited before use in a wage index. These commenters argued that imposing an additional 1-year lag on wage data ignores the current trends in the labor markets, fails to recognize fully those areas where severe nursing shortages necessitate paying a higher rate to attract nurses, and results in a less accurate reimbursement rate. In addition, a few commenters were concerned about the burden on hospital-based providers that would have to maintain two wage index systems, one for the hospital and another for the SNF.

Response: Based on our review of the comments, we have determined to continue using the most current available wage index data in determining the SNF payment rates, and we are not adopting the position taken in the May 16, 2003 proposed rule.

Comment: A few commenters, while opposing the use of the most recently published wage index values, urged us to make a retroactive wage index adjustment to account for errors in a prior year's reporting of hospital wage data that lowered payments to SNFs located in the Baltimore MSA.

Response: The SNF PPS does not include a methodology for retroactive adjustments to the wage index. The payment rates and wage indices are applied prospectively. Similarly, any corrections to the wage indices are also applied prospectively. We rely on the best available data reported by hospitals and audited by our fiscal intermediaries. Clearly, retroactive application of these wage index changes would jeopardize the prospective nature of the system and introduce an even higher level of instability.

The commenters cited § 412.63(x)(2) of the regulations to support their request for this retroactive adjustment. However, this section applies solely to mid-year corrections of the wage index for inpatient hospitals and applies only in cases where the FI or CMS made an error in tabulating the hospital data. In this case, the error was made by the providers and not by either the FI or by CMS. Moreover, the errors in the as-reported data were subject to public review and comment before adoption under the SNF PPS. In fact, this public process has facilitated correction of the data going forward. Unfortunately, the errors in this case were not identified until the data were audited. By that time, it was too late to make a mid-year rate correction. While we regret the impact on Maryland providers, we note that this situation is inherent in a system that uses more recent data. Under a policy of using the most recently published wage index values, the correction to the Baltimore MSA could have been incorporated in the published wage index and resulted in revised reimbursement to providers in the Baltimore MSA.

Comment: Several commenters expressed concern that we may have discarded the SNF-specific wage index without further work or development to ensure its accuracy. Another pointed out that we already have the legal authority to develop and collect data necessary to establish an SNF wage index through the Social Security Act Amendments of 1994 (Pub. L. 103–432). These commenters urged us to work with the industry to educate SNF providers, improve the cost reporting tools we use to collect the data, and immediately seek funding for the full-scale auditing of SNF data that would be needed to create and validate an SNF-specific wage index. A few commenters suggested that we should commit the resources required to implement an SNF-specific wage index not later than FY 2006. One commenter expressed concern that the SNF community does not participate in the hospital wage data collection process. However, a few commenters cautioned us against a precipitous conversion until we are sure that the SNF-specific wage index has been tested to ensure a high level of stability and accuracy.

Response: As we discussed in the May 10, 2001 proposed rule (66 FR 24010 through 24011), there is a great deal of volatility in the SNF-specific wage index prototype—not only between it and the hospital wage data, but also between the 2 years of data that we used in developing the SNF-specific wage index prototype. As many commenters suggested, the data could be improved if we were to establish better controls, edits, and screens of the data, and insist that more of the provider's data be audited to ensure its accuracy. We are committed to a process to ensure the accuracy of the data and have already implemented several edits and screens to improve the quality of data reported. We have made several corrections and changes to the cost reports/edits/screens as a result of consultation with industry representatives. However, these changes were made prospectively, and the full year's data needed to evaluate these efforts are not yet available. Moreover, while we are proceeding with our analysis, we still have concerns about the accuracy of the data being reported. Hospitals have been reporting wage and hourly data for years, yet the FIs and providers must still spend a considerable amount of time resolving problems and changes to the data to derive the published hospital wage index. The problem experienced by Maryland providers in FY 2001 illustrates the difficulty of timely verification of wage data, which often results in changes being made to the wage index even after the update regulations are published.

We agree that auditing all SNFs would provide more accurate and reliable data; however, this approach involves a significant commitment of our resources and our contractors and may place a significant recordkeeping and reporting burden on providers. Developing a desk review and audit program similar to what is required in the hospital setting would, at a minimum, require significant resources. The FIs that are involved in preparing the hospital wage data currently spend considerable resources to ensure the accuracy of the wage data submitted by approximately 6,000 hospitals. As we noted in the July 31, 2001 final rule (66 FR 39579), this process involves editing, reviewing, auditing, and performing desk reviews of the data. Requiring FIs to do the same for the approximately 14,000 SNFs would nearly triple the contractors' workload and budgets in this area. While we have noted the industry concerns and funding needs, there are no funds currently available to develop this system to the point where we could rely on the data that any such system would produce. We are committed to continuing our investigation of an SNF-specific wage index that would enhance our current payment methodology.

However, we do not expect to propose a SNF-specific wage index until we can demonstrate that it would significantly improve our ability to determine payments for facilities, and justify the resources required to collect the data, as well as the increased burden on providers. We also want to point out that the development of the hospital wage data can also be scrutinized and evaluated by the SNF industry when commenting on the hospital proposed rule that is published each spring. Therefore, because of the problems associated with the current SNF-specific data, and our inability to demonstrate that an SNF-specific wage index would be more reflective of the wages and salaries paid in a specific area, we continue to believe that hospital wage data are the most appropriate data for adjusting payments made to SNFs.

Comment: A small number of commenters suggested that if SNFs are going to use the hospital wage index, several components of the hospital PPS should be immediately applied to SNFs. For example, one commenter suggested that we ensure that no MSA wage index value is lower than the State-wide rural wage index. Other commenters recommended an immediate change in SNF PPS methodology to allow provider reclassification.

Response: As discussed above, the calculation of the wage indices must be made in a budget neutral manner. If we adopted this hospital PPS provision and established a wage index floor, there would be no change in the aggregate reimbursement for SNFs. While we are not convinced a state-wide floor would provide a more accurate wage index, we encourage input from the industry on why this could provide a more accurate wage index, noting that the redistribution of funds would reduce payments to some providers while it increased payments to others.

Under section 315 of the BIPA, the Congress authorized the use of a reclassification methodology in the SNF PPS that would allow providers to seek geographic reclassification. However, the statute specifically noted that such reclassification could not be implemented until we have collected the data necessary to establish an SNF-specific wage index. Accordingly, under the current legislative authority, we are prohibited from implementing an SNF reclassification system until reliable data in this area become available.

We would also like to point out on June 6, 2003, the Office of Management and Budget (OMB) issued OMB Bulletin No. 03–04, announcing revised definitions of Metropolitan Statistical Areas, and new definitions of Micropolitan Statistical Areas and Combined Statistical Areas. A copy of the bulletin may be attained at the following Internet address: *http://www.whitehouse.gov/omb/bulletins/b03–04.html*.

These new definitions will not be applied to the FY 2004 wage index. However, we will be studying the new definitions and their impact and, if warranted, may adopt them in the future, using appropriate administrative processes. To the extent these definitions are used, the concerns expressed by many for the use of a geographical reclassification system may be mitigated.

2. Determining the Labor-Related Portion of the SNF PPS Rate

The wage index adjustment is applied to the labor-related portion of the Federal rate, which in FY 2004 is 76.372 percent of the total rate. This percentage reflects the labor-related relative importance for FY 2004. The labor-related relative importance is calculated from the SNF market basket, and approximates the labor-related portion of the total costs after taking into account historical and projected price changes between the base year and FY 2004. The price proxies that move the different cost categories in the market basket do not necessarily change at the same rate, and the relative importance captures these changes. Accordingly, the relative importance figure more closely reflects the cost share weights for FY 2004 than the base year weights from the SNF market basket.

We calculate the labor-related relative importance for FY 2004 in four steps. First, we compute the FY 2004 price index level for the total market basket and each cost category of the market basket. Second, we calculate a ratio for each cost category by dividing the FY 2004 price index level for that cost category by the total market basket price index level. Third, we determine the FY 2004 relative importance for each cost category by multiplying this ratio by the base year (FY 1997) weight. Finally, we sum the FY 2004 relative importance for each of the labor-related cost categories (wages and salaries, employee benefits, nonmedical professional fees, labor-intensive services, and capital-related expenses) to produce the FY 2004 labor-related relative importance. Tables 5 and 6 show the Federal rates by labor-related and non-labor-related components.

3. Calculating the Budget Neutrality Factor

Section 1888(e)(4)(G)(ii) of the Act also requires that we apply this wage index in a manner that does not result in aggregate payments that are greater or lesser than would otherwise be made in the absence of the wage adjustment. In this sixth PPS year (Federal rates effective October 1, 2003), we are applying the wage index applicable to SNF payments using the most recent hospital wage data applicable to FY 2004 payments (as discussed in the following comments), and applying an adjustment to fulfill the budget neutrality requirement. This requirement is met by multiplying each of the components of the unadjusted Federal rates by a factor equal to the ratio of the volume weighted mean wage adjustment factor (using the wage index from the previous year) to the volume weighted mean wage adjustment factor, using the wage index for the fiscal year beginning October 1, 2003. The same volume weights are used in both the numerator and denominator and will be derived from 1997 Medicare Provider Analysis and Review File (MEDPAR) data. The wage adjustment factor used in this calculation is defined as the labor share of the rate component multiplied by the wage index plus the non-labor share. The budget neutrality factor for this year is 1.005. In order to give the public a sense of the magnitude of this adjustment, last year's factor was 0.9997.

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Table 5
Case-Mix Adjusted Federal Rates for Urban SNFs
By Labor and Non-Labor Component

RUG III Category	Total Rate	Labor Portion	Non-Labor Portion
RUC	455.52	347.89	107.63
RUB	410.03	313.15	96.88
RUA	387.94	296.28	91.66
RVC	351.19	268.21	82.98
RVB	339.50	259.28	80.22
RVA	309.61	236.46	73.15
RHC	322.09	245.99	76.10
RHB	296.10	226.14	69.96
RHA	271.41	207.28	64.13
RMC	317.15	242.21	74.94
RMB	283.36	216.41	66.95
RMA	266.46	203.50	62.96
RLB	252.67	192.97	59.70
RLA	212.38	162.20	50.18
SE3	300.14	229.22	70.92
SE2	259.85	198.45	61.40
SE1	231.26	176.62	54.64
SSC	226.06	172.65	53.41
SSB	215.67	164.71	50.96
SSA	210.47	160.74	49.73
CC2	224.77	171.66	53.11
CC1	207.87	158.75	49.12
CB2	197.47	150.81	46.66
CB1	188.38	143.87	44.51
CA2	187.08	142.88	44.20
CA1	176.68	134.93	41.75
IB2	168.88	128.98	39.90
IB1	166.28	126.99	39.29
IA2	153.29	117.07	36.22
IA1	148.09	113.10	34.99
BB2	167.58	127.98	39.60
BB1	163.68	125.01	38.67
BA2	151.99	116.08	35.91
BA1	141.59	108.14	33.45
PE2	181.88	138.91	42.97
PE1	179.28	136.92	42.36
PD2	172.78	131.96	40.82
PD1	170.18	129.97	40.21
PC2	163.68	125.01	38.67
PC1	162.38	124.01	38.37
PB2	145.49	111.11	34.38
PB1	144.19	110.12	34.07
PA2	142.89	109.13	33.76
PA1	138.99	106.15	32.84

Table 6
Case-Mix Adjusted Federal Rates for Rural SNFs by Labor and Non-Labor Component

RUG III Category	Total Rate	Labor Portion	Non-Labor Portion
RUC	482.96	368.85	114.11
RUB	439.50	335.65	103.85
RUA	418.39	319.53	98.86
RVC	367.02	280.30	86.72
RVB	355.85	271.77	84.08
RVA	327.29	249.96	77.33
RHC	330.11	252.11	78.00
RHB	305.28	233.15	72.13
RHA	281.69	215.13	66.56
RMC	322.10	245.99	76.11
RMB	289.81	221.33	68.48
RMA	273.67	209.01	64.66
RLB	253.91	193.92	59.99
RLA	215.42	164.52	50.90
SE3	292.39	223.30	69.09
SE2	253.90	193.91	59.99
SE1	226.59	173.05	53.54
SSC	221.62	169.26	52.36
SSB	211.69	161.67	50.02
SSA	206.72	157.88	48.84
CC2	220.38	168.31	52.07
CC1	204.24	155.98	48.26
CB2	194.31	148.40	45.91
CB1	185.61	141.75	43.86
CA2	184.37	140.81	43.56
CA1	174.44	133.22	41.22
IB2	166.99	127.53	39.46
IB1	164.51	125.64	38.87
IA2	152.09	116.15	35.94
IA1	147.12	112.36	34.76
BB2	165.75	126.59	39.16
BB1	162.02	123.74	38.28
BA2	150.85	115.21	35.64
BA1	140.92	107.62	33.30
PE2	179.41	137.02	42.39
PE1	176.92	135.12	41.80
PD2	170.72	130.38	40.34
PD1	168.23	128.48	39.75
PC2	162.02	123.74	38.28
PC1	160.78	122.79	37.99
PB2	144.64	110.46	34.18
PB1	143.40	109.52	33.88
PA2	142.16	108.57	33.59
PA1	138.43	105.72	32.71

BILLING CODE 4120–01–C

TABLE 7.—WAGE INDEX FOR URBAN AREAS

Urban area (constituent counties or county equivalents)	Wage index
0040 Abilene, TX	0.7596
Taylor, TX	
0060 Aguadilla, PR	0.4289
Aguada, PR	
Aguadilla, PR	
Moca, PR	
0080 Akron, OH	0.9208
Portage, OH	
Summit, OH	
0120 Albany, GA	1.0819
Dougherty, GA	
Lee, GA	
0160 Albany-Schenectady-Troy, NY	0.8455
Albany, NY	
Montgomery, NY	
Rensselaer, NY	
Saratoga, NY	
Schenectady, NY	
Schoharie, NY	
0200 Albuquerque, NM	0.9263
Bernalillo, NM	
Sandoval, NM	
Valencia, NM	
0220 Alexandria, LA	0.7987
Rapides, LA	
0240 Allentown-Bethlehem-Easton, PA	0.9682
Carbon, PA	
Lehigh, PA	
Northampton, PA	
0280 Altoona, PA	0.8771
Blair, PA	
0320 Amarillo, TX	0.8950
Potter, TX	
Randall, TX	
0380 Anchorage, AK	1.2167
Anchorage, AK	
0440 Ann Arbor, MI	1.1029
Lenawee, MI	
Livingston, MI	
Washtenaw, MI	
0450 Anniston, AL	0.8058
Calhoun, AL	
0460 Appleton-Oshkosh-Neenah, WI	0.8999
Calumet, WI	
Outagamie, WI	
Winnebago, WI	
0470 Arecibo, PR	0.4138
Arecibo, PR	
Camuy, PR	
Hatillo, PR	
0480 Asheville, NC	0.9680
Buncombe, NC	
Madison, NC	
0500 Athens, GA	0.9778
Clarke, GA	
Madison, GA	
Oconee, GA	
0520 Atlanta, GA	1.0089
Barrow, GA	
Bartow, GA	
Carroll, GA	
Cherokee, GA	
Clayton, GA	
Cobb, GA	
Coweta, GA	
De Kalb, GA	
Douglas, GA	
Fayette, GA	
Forsyth, GA	
Fulton, GA	
Gwinnett, GA	
Henry, GA	
Newton, GA	
Paulding, GA	
Pickens, GA	
Rockdale, GA	
Spalding, GA	
Walton, GA	
0560 Atlantic City-Cape May, NJ	1.0751
Atlantic City, NJ	
Cape May, NJ	
0580 Auburn-Opelika, AL	0.8460
Lee, AL	
0600 Augusta-Aiken, GA-SC	0.9587
Columbia, GA	
McDuffie, GA	
Richmond, GA	
Aiken, SC	
Edgefield, SC	
0640 Austin-San Marcos, TX	0.9570
Bastrop, TX	
Caldwell, TX	
Hays, TX	
Travis, TX	
Williamson, TX	
0680 Bakersfield, CA	0.9770
Kern, CA	
0720 Baltimore, MD	0.9879
Anne Arundel, MD	
Baltimore, MD	
Baltimore City, MD	
Carroll, MD	
Harford, MD	
Howard, MD	
Queen Annes, MD	
0733 Bangor, ME	0.9864
Penobscot, ME	
0743 Barnstable-Yarmouth, MA	1.2904
Barnstable, MA	
0760 Baton Rouge, LA	0.8372
Ascension, LA	
East Baton Rouge, LA	
Livingston, LA	
West Baton Rouge, LA	
0840 Beaumont-Port Arthur, TX	0.8390
Hardin, TX	
Jefferson, TX	
Orange, TX	
0860 Bellingham, WA	1.1710
Whatcom, WA	
0870 Benton Harbor, MI	0.8835
Berrien, MI	
0875 Bergen-Passaic, NJ	1.1644
Bergen, NJ	
Passaic, NJ	
0880 Billings, MT	0.8925
Yellowstone, MT	
0920 Biloxi-Gulfport-Pascagoula, MS	0.8993
Hancock, MS	
Harrison, MS	
Jackson, MS	
0960 Binghamton, NY	0.8394
Broome, NY	
Tioga, NY	
1000 Birmingham, AL	0.9175
Blount, AL	
Jefferson, AL	
St. Clair, AL	
Shelby, AL	
1010 Bismarck, ND	0.7933
Burleigh, ND	
Morton, ND	
1020 Bloomington, IN	0.8627
Monroe, IN	
1040 Bloomington-Normal, IL	0.8796
McLean, IL	
1080 Boise City, ID	0.9172
Ada, ID	
Canyon, ID	
1123 Boston-Worcester-Lawrence-Lowell-Brockton, MA-NH	1.1188
Bristol, MA	
Essex, MA	
Middlesex, MA	
Norfolk, MA	
Plymouth, MA	
Suffolk, MA	
Worcester, MA	
Hillsborough, NH	
Merrimack, NH	
Rockingham, NH	
Strafford, NH	
1125 Boulder-Longmont, CO	1.0008
Boulder, CO	
1145 Brazoria, TX	0.8105
Brazoria, TX	
1150 Bremerton, WA	1.0537
Kitsap, WA	
1240 Brownsville-Harlingen-San Benito, TX	1.0261
Cameron, TX	
1260 Bryan-College Station, TX	0.8983
Brazos, TX	
1280 Buffalo-Niagara Falls, NY	0.9565
Erie, NY	
Niagara, NY	
1303 Burlington, VT	0.9665
Chittenden, VT	
Franklin, VT	
Grand Isle, VT	
1310 Caguas, PR	0.4141
Caguas, PR	
Cayey, PR	
Cidra, PR	
Gurabo, PR	
San Lorenzo, PR	
1320 Canton-Massillon, OH	0.9034
Carroll, OH	
Stark, OH	
1350 Casper, WY	0.9058
Natrona, WY	
1360 Cedar Rapids, IA	0.8838
Linn, IA	
1400 Champaign-Urbana, IL	0.9867
Champaign, IL	
1440 Charleston-North Charleston, SC	0.9294
Berkeley, SC	
Charleston, SC	
Dorchester, SC	
1480 Charleston, WV	0.8845

TABLE 7.—WAGE INDEX FOR URBAN AREAS—Continued

Urban area (constituent counties or county equivalents)	Wage index
Kanawha, WV	
Putnam, WV	
1520 Charlotte-Gastonia-Rock Hill, NC-SC	0.9721
Cabarrus, NC	
Gaston, NC	
Lincoln, NC	
Mecklenburg, NC	
Rowan, NC	
Stanly, NC	
Union, NC	
York, SC	
1540 Charlottesville, VA	0.9985
Albemarle, VA	
Charlottesville City, VA	
Fluvanna, VA	
Greene, VA	
1560 Chattanooga, TN-GA	0.9049
Catoosa, GA	
Dade, GA	
Walker, GA	
Hamilton, TN	
Marion, TN	
1580 Cheyenne, WY	0.8760
Laramie, WY	
1600 Chicago, IL	1.0848
Cook, IL	
De Kalb, IL	
Du Page, IL	
Grundy, IL	
Kane, IL	
Kendall, IL	
Lake, IL	
McHenry, IL	
Will, IL	
1620 Chico-Paradise, CA	1.0152
Butte, CA	
1640 Cincinnati, OH-KY-IN	0.9375
Dearborn, IN	
Ohio, IN	
Boone, KY	
Campbell, KY	
Gallatin, KY	
Grant, KY	
Kenton, KY	
Pendleton, KY	
Brown, OH	
Clermont, OH	
Hamilton, OH	
Warren, OH	
1660 Clarksville-Hopkinsville, TN-KY	0.8211
Christian, KY	
Montgomery, TN	
1680 Cleveland-Lorain-Elyria, OH	0.9632
Ashtabula, OH	
Geauga, OH	
Cuyahoga, OH	
Lake, OH	
Lorain, OH	
Medina, OH	
1720 Colorado Springs, CO	0.9793
El Paso, CO	
1740 Columbia, MO	0.8660
Boone, MO	
1760 Columbia, SC	0.8866
Lexington, SC	
Richland, SC	
1800 Columbus, GA-AL	0.8659
Russell, AL	
Chattanoochee, GA	
Harris, GA	
Muscogee, GA	
1840 Columbus, OH	0.9609
Delaware, OH	
Fairfield, OH	
Franklin, OH	
Licking, OH	
Madison, OH	
Pickaway, OH	
1880 Corpus Christi, TX	0.8486
Nueces, TX	
San Patricio, TX	
1890 Corvallis, OR	1.1470
Benton, OR	
1900 Cumberland, MD-WV	0.8166
Allegany, MD	
Mineral, WV	
1920 Dallas, TX	0.9934
Collin, TX	
Dallas, TX	
Denton, TX	
Ellis, TX	
Henderson, TX	
Hunt, TX	
Kaufman, TX	
Rockwall, TX	
1950 Danville, VA	0.8998
Danville City, VA	
Pittsylvania, VA	
1960 Davenport-Moline-Rock Island, IA-IL	0.8949
Scott, IA	
Henry, IL	
Rock Island, IL	
2000 Dayton-Springfield, OH	0.9479
Clark, OH	
Greene, OH	
Miami, OH	
Montgomery, OH	
2020 Daytona Beach, FL	0.9042
Flagler, FL	
Volusia, FL	
2030 Decatur, AL	0.8793
Lawrence, AL	
Morgan, AL	
2040 Decatur, IL	0.8128
Macon, IL	
2080 Denver, CO	1.0793
Adams, CO	
Arapahoe, CO	
Denver, CO	
Douglas, CO	
Jefferson, CO	
2120 Des Moines, IA	0.9069
Dallas, IA	
Polk, IA	
Warren, IA	
2160 Detroit, MI	1.0060
Lapeer, MI	
Macomb, MI	
Monroe, MI	
Oakland, MI	
St. Clair, MI	
Wayne, MI	
2180 Dothan, AL	0.7710
Dale, AL	
Houston, AL	
2190 Dover, DE	0.9765
Kent, DE	
2200 Dubuque, IA	0.8850
Dubuque, IA	
2240 Duluth-Superior, MN-WI	1.0130
St. Louis, MN	
Douglas, WI	
2281 Dutchess County, NY	1.0890
Dutchess, NY	
2290 Eau Claire, WI	0.9027
Chippewa, WI	
Eau Claire, WI	
2320 El Paso, TX	0.9159
El Paso, TX	
2330 Elkhart-Goshen, IN	0.9744
Elkhart, IN	
2335 Elmira, NY	0.8343
Chemung, NY	
2340 Enid, OK	0.8524
Garfield, OK	
2360 Erie, PA	0.8566
Erie, PA	
2400 Eugene-Springfield, OR	1.1410
Lane, OR	
2440 Evansville-Henderson, IN-KY	0.8395
Posey, IN	
Vanderburgh, IN	
Warrick, IN	
Henderson, KY	
2520 Fargo-Moorhead, ND-MN	0.9758
Clay, MN	
Cass, ND	
2560 Fayetteville, NC	0.8950
Cumberland, NC	
2580 Fayetteville-Springdale-Rogers, AR	0.8362
Benton, AR	
Washington, AR	
2620 Flagstaff, AZ-UT	1.1287
Coconino, AZ	
Kane, UT	
2640 Flint, MI	1.0814
Genesee, MI	
2650 Florence, AL	0.7716
Colbert, AL	
Lauderdale, AL	
2655 Florence, SC	0.8673
Florence, SC	
2670 Fort Collins-Loveland, CO	1.0067
Larimer, CO	
2680 Ft. Lauderdale, FL	1.0122
Broward, FL	
2700 Fort Myers-Cape Coral, FL	0.9776
Lee, FL	
2710 Fort Pierce-Port St. Lucie, FL	0.9968
Martin, FL	
St. Lucie, FL	
2720 Fort Smith, AR-OK	0.8390
Crawford, AR	
Sebastian, AR	
Sequoyah, OK	
2750 Fort Walton Beach, FL	0.8930
Okaloosa, FL	
2760 Fort Wayne, IN	0.9546
Adams, IN	
Allen, IN	
De Kalb, IN	

TABLE 7.—WAGE INDEX FOR URBAN AREAS—Continued

Urban area (constituent counties or county equivalents)	Wage index
Huntington, IN	
Wells, IN	
Whitley, IN	
2800 Fort Worth-Arlington, TX	0.9321
Hood, TX	
Johnson, TX	
Parker, TX	
Tarrant, TX	
2840 Fresno, CA	1.0053
Fresno, CA	
Madera, CA	
2880 Gadsden, AL	0.8173
Etowah, AL	
2900 Gainesville, FL	0.9653
Alachua, FL	
2920 Galveston-Texas City, TX	0.9242
Galveston, TX	
2960 Gary, IN	0.9372
Lake, IN	
Porter, IN	
2975 Glens Falls, NY	0.8441
Warren, NY	
Washington, NY	
2980 Goldsboro, NC	0.8587
Wayne, NC	
2985 Grand Forks, ND-MN	0.8601
Polk, MN	
Grand Forks, ND	
2995 Grand Junction, CO	0.9594
Mesa, CO.	
3000 Grand Rapids-Muskegon-Holland, MI	0.9430
Allegan, MI	
Kent, MI	
Muskegon, MI	
Ottawa, MI	
3040 Great Falls, MT	0.8773
Cascade, MT	
3060 Greeley, CO	0.9334
Weld, CO	
3080 Green Bay, WI	0.9422
Brown, WI	
3120 Greensboro-Winston-Salem-High Point, NC	0.9129
Alamance, NC	
Davidson, NC	
Davie, NC	
Forsyth, NC	
Guilford, NC	
Randolph, NC	
Stokes, NC	
Yadkin, NC	
3150 Greenville, NC	0.9061
Pitt, NC	
3160 Greenville-Spartanburg-Anderson, SC	0.9297
Anderson, SC	
Cherokee, SC	
Greenville, SC	
Pickens, SC	
Spartanburg, SC	
3180 Hagerstown, MD	0.9135
Washington, MD	
3200 Hamilton-Middletown, OH	0.9176
Butler, OH	
3240 Harrisburg-Lebanon-Carlisle, PA	0.9127
Cumberland, PA	
Dauphin, PA	
Lebanon, PA	
Perry, PA	
3283 Hartford, CT	1.1508
Hartford, CT	
Litchfield, CT	
Middlesex, CT	
Tolland, CT	
3285 Hattiesburg, MS	0.7278
Forrest, MS	
Lamar, MS	
3290 Hickory-Morganton-Lenoir, NC	0.9205
Alexander, NC	
Burke, NC	
Caldwell, NC	
Catawba, NC	
3320 Honolulu, HI	1.1053
Honolulu, HI	
3350 Houma, LA	0.7717
Lafourche, LA	
Terrebonne, LA	
3360 Houston, TX	0.9794
Chambers, TX	
Fort Bend, TX	
Harris, TX	
Liberty, TX	
Montgomery, TX	
Waller, TX	
3400 Huntington-Ashland, WV-KY-OH	0.9556
Boyd, KY	
Carter, KY	
Greenup, KY	
Lawrence, OH	
Cabell, WV	
Wayne, WV	
3440 Huntsville, AL	0.9208
Limestone, AL	
Madison, AL	
3480 Indianapolis, IN	0.9875
Boone, IN	
Hamilton, IN	
Hancock, IN	
Hendricks, IN	
Johnson, IN	
Madison, IN	
Marion, IN	
Morgan, IN	
Shelby, IN	
3500 Iowa City, IA	0.9510
Johnson, IA	
3520 Jackson, MI	0.8950
Jackson, MI	
3560 Jackson, MS	0.8324
Hinds, MS	
Madison, MS	
Rankin, MS	
3580 Jackson, TN	0.8948
Chester, TN	
Madison, TN	
3600 Jacksonville, FL	0.9490
Clay, FL	
Duval, FL	
Nassau, FL	
St. Johns, FL	
3605 Jacksonville, NC	0.8510
Onslow, NC	
3610 Jamestown, NY	0.7730
Chautaqua, NY	
3620 Janesville-Beloit, WI	0.9244
Rock, WI	
3640 Jersey City, NJ	1.1070
Hudson, NJ	
3660 Johnson City-Kingsport-Bristol, TN-VA	0.8220
Carter, TN	
Hawkins, TN	
Sullivan, TN	
Unicoi, TN	
Washington, TN	
Bristol City, VA	
Scott, VA	
Washington, VA	
3680 Johnstown, PA	0.8125
Cambria, PA	
Somerset, PA	
3700 Jonesboro, AR	0.7762
Craighead, AR	
3710 Joplin, MO	0.8646
Jasper, MO	
Newton, MO	
3720 Kalamazoo-Battle Creek, MI	1.0458
Calhoun, MI	
Kalamazoo, MI	
Van Buren, MI	
3740 Kankakee, IL	1.0377
Kankakee, IL	
3760 Kansas City, KS-MO	0.9675
Johnson, KS	
Leavenworth, KS	
Miami, KS	
Wyandotte, KS	
Cass, MO	
Clay, MO	
Clinton, MO	
Jackson, MO	
Lafayette, MO	
Platte, MO	
Ray, MO	
3800 Kenosha, WI	0.9721
Kenosha, WI	
3810 Killeen-Temple, TX	0.9122
Coryell, TX	
3840 Knoxville, TN	0.8784
Anderson, TN	
Blount, TN	
Knox, TN	
Loudon, TN	
Sevier, TN	
Union, TN	
3850 Kokomo, IN	0.9008
Howard, IN	
Tipton, IN	
3870 La Crosse, WI-MN	0.9210
Houston, MN	
La Crosse, WI	
3880 Lafayette, LA	0.8156
Acadia, LA	
Lafayette, LA	
St. Landry, LA	
St. Martin, LA	
3920 Lafayette, IN	0.8549
Clinton, IN	
Tippecanoe, IN	
3960 Lake Charles, LA	0.7809
Calcasieu, LA	
3980 Lakeland-Winter Haven, FL	0.8775
Polk, FL	

TABLE 7.—WAGE INDEX FOR URBAN AREAS—Continued

Urban area (constituent counties or county equivalents)	Wage index
4000 Lancaster, PA	0.9244
Lancaster, PA	
4040 Lansing-East Lansing, MI	0.9675
Clinton, MI	
Eaton, MI	
Ingham, MI	
4080 Laredo, TX	0.8059
Webb, TX	
4100 Las Cruces, NM	0.8653
Dona Ana, NM	
4120 Las Vegas, NV-AZ	1.1481
Mohave, AZ	
Clark, NV	
Nye, NV	
4150 Lawrence, KS	0.8642
Douglas, KS	
4200 Lawton, OK	0.8234
Comanche, OK	
4243 Lewiston-Auburn, ME	0.9345
Androscoggin, ME	
4280 Lexington, KY	0.8650
Bourbon, KY	
Clark, KY	
Fayette, KY	
Jessamine, KY	
Madison, KY	
Scott, KY	
Woodford, KY	
4320 Lima, OH	0.9483
Allen, OH	
Auglaize, OH	
4360 Lincoln, NE	0.9992
Lancaster, NE	
4400 Little Rock-North Little Rock, AR	0.8887
Faulkner, AR	
Lonoke, AR	
Pulaski, AR	
Saline, AR	
4420 Longview-Marshall, TX	0.9076
Gregg, TX	
Harrison, TX	
Upshur, TX	
4480 Los Angeles-Long Beach, CA	1.1748
Los Angeles, CA	
4520 Louisville, KY-IN	0.9205
Clark, IN	
Floyd, IN	
Harrison, IN	
Scott, IN	
Bullitt, KY	
Jefferson, KY	
Oldham, KY	
4600 Lubbock, TX	0.8238
Lubbock, TX	
4640 Lynchburg, VA	0.9097
Amherst, VA	
Bedford City, VA	
Bedford, VA	
Campbell, VA	
Lynchburg City, VA	
4680 Macon, GA	0.8916
Bibb, GA	
Houston, GA	
Jones, GA	
Peach, GA	
Twiggs, GA	
4720 Madison, WI	1.0222
Dane, WI	
4800 Mansfield, OH	0.8210
Crawford, OH	
Richland, OH	
4840 Mayaguez, PR	0.4776
Anasco, PR	
Cabo Rojo, PR	
Hormigueros, PR	
Mayaguez, PR	
Sabana Grande, PR	
San German, PR	
4880 McAllen-Edinburg-Mission, TX	0.8347
Hidalgo, TX	
4890 Medford-Ashland, OR	1.0729
Jackson, OR	
4900 Melbourne-Titusville-Palm Bay, FL	0.9736
Brevard, Fl	
4920 Memphis, TN-AR-MS	0.8973
Crittenden, AR	
De Soto, MS	
Fayette, TN	
Shelby, TN	
Tipton, TN	
4940 Merced, CA	0.9651
Merced, CA	
5000 Miami, FL	0.9854
Dade, FL	
5015 Middlesex-Somerset-Hunterdon, NJ	1.1320
Hunterdon, NJ	
Middlesex, NJ	
Somerset, NJ	
5080 Milwaukee-Waukesha, WI	0.9947
Milwaukee, WI	
Ozaukee, WI	
Washington, WI	
Waukesha, WI	
5120 Minneapolis-St Paul, MN-WI	1.0957
Anoka, MN	
Carver, MN	
Chisago, MN	
Dakota, MN	
Hennepin, MN	
Isanti, MN	
Ramsey, MN	
Scott, MN	
Sherburne, MN	
Washington, MN	
Wright, MN	
Pierce, WI	
St. Croix, WI	
5140 Missoula, MT	0.8683
Missoula, MT	
5160 Mobile, AL	0.7962
Baldwin, AL	
Mobile, AL	
5170 Modesto, CA	1.1230
Stanislaus, CA	
5190 Monmouth-Ocean, NJ	1.0912
Monmouth, NJ	
Ocean, NJ	
5200 Monroe, LA	0.7890
Ouachita, LA	
5240 Montgomery, AL	0.7875
Autauga, AL	
Elmore, AL	
Montgomery, AL	
5280 Muncie, IN	0.8739
Delaware, IN	
5330 Myrtle Beach, SC	0.9075
Horry, SC	
5345 Naples, FL	0.9750
Collier, FL	
5360 Nashville, TN	0.9815
Cheatham, TN	
Davidson, TN	
Dickson, TN	
Robertson, TN	
Rutherford TN	
Sumner, TN	
Williamson, TN	
Wilson, TN	
5380 Nassau-Suffolk, NY	1.2933
Nassau, NY	
Suffolk, NY	
5483 New Haven-Bridgeport-Stamford-Waterbury-Danbury, CT	1.2335
Fairfield, CT	
New Haven, CT	
5523 New London-Norwich, CT	1.1584
New London, CT	
5560 New Orleans, LA	0.9137
Jefferson, LA	
Orleans, LA	
Plaquemines, LA	
St. Bernard, LA	
St. Charles, LA	
St. James, LA	
St. John The Baptist, LA	
St. Tammany, LA	
5600 New York, NY	1.3913
Bronx, NY	
Kings, NY	
New York, NY	
Putnam, NY	
Queens, NY	
Richmond, NY	
Rockland, NY	
Westchester, NY	
5640 Newark, NJ	1.1471
Essex, NJ	
Morris, NJ	
Sussex, NJ	
Union, NJ	
Warren, NJ	
5660 Newburgh, NY-PA	1.1462
Orange, NY	
Pike, PA	
5720 Norfolk-Virginia Beach-Newport News, VA-NC	0.8584
Currituck, NC	
Chesapeake City, VA	
Gloucester, VA	
Hampton City, VA	
Isle of Wight, VA	
James City, VA	
Mathews, VA	
Newport News City, VA	
Norfolk City, VA	
Poquoson City, VA	
Portsmouth City, VA	
Suffolk City, VA	
Virginia Beach City, VA	
Williamsburg City, VA	
York, VA	

TABLE 7.—WAGE INDEX FOR URBAN AREAS—Continued

Urban area (constituent counties or county equivalents)	Wage index
5775 Oakland, CA	1.4860
Alameda, CA	
Contra Costa, CA	
5790 Ocala, FL	0.9689
Marion, FL	
5800 Odessa-Midland, TX	0.9290
Ector, TX	
Midland, TX	
5880 Oklahoma City, OK	0.8948
Canadian, OK	
Cleveland, OK	
Logan, OK	
McClain, OK	
Oklahoma, OK	
Pottawatomie, OK	
5910 Olympia, WA	1.0919
Thurston, WA	
5920 Omaha, NE-IA	0.9705
Pottawattamie, IA	
Cass, NE	
Douglas, NE	
Sarpy, NE	
Washington, NE	
5945 Orange County, CA	1.1326
Orange, CA	
5960 Orlando, FL	0.9615
Lake, FL	
Orange, FL	
Osceola, FL	
Seminole, FL	
5990 Owensboro, KY	0.8340
Daviess, KY	
6015 Panama City, FL	0.8169
Bay, FL	
6020 Parkersburg-Marietta, WV-OH	0.8007
Washington, OH	
Wood, WV	
6080 Pensacola, FL	0.8672
Escambia, FL	
Santa Rosa, FL	
6120 Peoria-Pekin, IL	0.8699
Peoria, IL	
Tazewell, IL	
Woodford, IL	
6160 Philadelphia, PA-NJ	1.0839
Burlington, NJ	
Camden, NJ	
Gloucester, NJ	
Salem, NJ	
Bucks, PA	
Chester, PA	
Delaware, PA	
Montgomery, PA	
Philadelphia, PA	
6200 Phoenix-Mesa, AZ	1.0088
Maricopa, AZ	
Pinal, AZ	
6240 Pine Bluff, AR	0.7833
Jefferson, AR	
6280 Pittsburgh, PA	0.8865
Allegheny, PA	
Beaver, PA	
Butler, PA	
Fayette, PA	
Washington, PA	
Westmoreland, PA	
6323 Pittsfield, MA	1.0234
Berkshire, MA	
6340 Pocatello, ID	0.9006
Bannock, ID	
6360 Ponce, PR	0.4689
Guayanilla, PR	
Juana Diaz, PR	
Penuelas, PR	
Ponce, PR	
Villalba, PR	
Yauco, PR	
6403 Portland, ME	0.9909
Cumberland, ME	
Sagadahoc, ME	
York, ME	
6440 Portland-Vancouver, OR-WA	1.1167
Clackamas, OR	
Columbia, OR	
Multnomah, OR	
Washington, OR	
Yamhill, OR	
Clark, WA	
6483 Providence-Warwick-Pawtucket, RI	1.0932
Bristol, RI	
Kent, RI	
Newport, RI	
Providence, RI	
Washington, RI	
6520 Provo-Orem, UT	0.9936
Utah, UT	
6560 Pueblo, CO	0.8743
Pueblo, CO	
6580 Punta Gorda, FL	0.9472
Charlotte, FL	
6600 Racine, WI	0.8778
Racine, WI	
6640 Raleigh-Durham-Chapel Hill, NC	0.9919
Chatham, NC	
Durham, NC	
Franklin, NC	
Johnston, NC	
Orange, NC	
Wake, NC	
6660 Rapid City, SD	0.8771
Pennington, SD	
6680 Reading, PA	0.9096
Berks, PA	
6690 Redding, CA	1.1306
Shasta, CA	
6720 Reno, NV	1.0639
Washoe, NV	
6740 Richland-Kennewick-Pasco, WA	1.0566
Benton, WA	
Franklin, WA	
6760 Richmond-Petersburg, VA	0.9311
Charles City County, VA	
Chesterfield, VA	
Colonial Heights City, VA	
Dinwiddie, VA	
Goochland, VA	
Hanover, VA	
Henrico, VA	
Hopewell City, VA	
New Kent, VA	
Petersburg City, VA	
Powhatan, VA	
Prince George, VA	
Richmond City, VA	
6780 Riverside-San Bernardino, CA	1.1296
Riverside, CA	
San Bernardino, CA	
6800 Roanoke, VA	0.8664
Botetourt, VA	
Roanoke, VA	
Roanoke City, VA	
Salem City, VA	
6820 Rochester, MN	1.1691
Olmsted, MN	
6840 Rochester, NY	0.9392
Genesee, NY	
Livingston, NY	
Monroe, NY	
Ontario, NY	
Orleans, NY	
Wayne, NY	
6880 Rockford, IL	0.9627
Boone, IL	
Ogle, IL	
Winnebago, IL	
6895 Rocky Mount, NC	0.9039
Edgecombe, NC	
Nash, NC	
6920 Sacramento, CA	1.1797
El Dorado, CA	
Placer, CA	
Sacramento, CA	
A6960 Saginaw-Bay City-Midland, MI	0.9992
Bay, MI	
Midland, MI	
Saginaw, MI	
6980 St. Cloud, MN	0.9468
Benton, MN	
Stearns, MN	
7000 St. Joseph, MO	0.9718
Andrews, MO	
Buchanan, MO	
7040 St. Louis, MO-IL	0.8996
Clinton, IL	
Jersey, IL	
Madison, IL	
Monroe, IL	
St. Clair, IL	
Franklin, MO	
Jefferson, MO	
Lincoln, MO	
St. Charles, MO	
St. Louis, MO	
St. Louis City, MO	
Warren, MO	
Sullivan City, MO	
7080 Salem, OR	1.0440
Marion, OR	
Polk, OR	
7120 Salinas, CA	1.4281
Monterey, CA	
7160 Salt Lake City-Ogden, UT	0.9873
Davis, UT	
Salt Lake, UT	
Weber, UT	
7200 San Angelo, TX	0.8500
Tom Green, TX	
7240 San Antonio, TX	0.8834
Bexar, TX	
Comal, TX	

TABLE 7.—WAGE INDEX FOR URBAN AREAS—Continued

Urban area (constituent counties or county equivalents)	Wage index
Guadalupe, TX	
Wilson, TX	
7320 San Diego, CA	1.1102
San Diego, CA	
7360 San Francisco, CA	1.4455
Marin, CA	
San Francisco, CA	
San Mateo, CA	
7400 San Jose, CA	1.4567
Santa Clara, CA	
7440 San Juan-Bayamon, PR	0.4880
Aguas Buenas, PR	
Barceloneta, PR	
Bayamon, PR	
Canovanas, PR	
Carolina, PR	
Catano, PR	
Ceiba, PR	
Comerio, PR	
Corozal, PR	
Dorado, PR	
Fajardo, PR	
Florida, PR	
Guaynabo, PR	
Humacao, PR	
Juncos, PR	
Los Piedras, PR	
Loiza, PR	
Luguillo, PR	
Manati, PR	
Morovis, PR	
Naguabo, PR	
Naranjito, PR	
Rio Grande, PR	
San Juan, PR	
Toa Alta, PR	
Toa Baja, PR	
Trujillo Alto, PR	
Vega Alta, PR	
Vega Baja, PR	
Yabucoa, PR	
7460 San Luis Obispo-Atascadero-Paso Robles, CA	1.1383
San Luis Obispo, CA	
7480 Santa Barbara-Santa Maria-Lompoc, CA	1.0399
Santa Barbara, CA	
7485 Santa Cruz-Watsonville, CA	1.2890
Santa Cruz, CA	
7490 Santa Fe, NM	1.0610
Los Alamos, NM	
Santa Fe, NM	
7500 Santa Rosa, CA	1.2825
Sonoma, CA	
7510 Sarasota-Bradenton, FL	0.9924
Manatee, FL	
Sarasota, FL	
7520 Savannah, GA	0.9433
Bryan, GA	
Chatham, GA	
Effingham, GA	
7560 Scranton—Wilkes-Barre—Hazleton, PA	0.8378
Columbia, PA	
Lackawanna, PA	
Luzerne, PA	
Wyoming, PA	
7600 Seattle-Bellevue-Everett, WA	1.1516
Island, WA	
King, WA	
Snohomish, WA	
7610 Sharon, PA	0.7719
Mercer, PA	
7620 Sheboygan, WI	0.8589
Sheboygan, WI	
7640 Sherman-Denison, TX	0.9661
Grayson, TX	
7680 Shreveport-Bossier City, LA	0.9047
Bossier, LA	
Caddo, LA	
Webster, LA	
7720 Sioux City, IA-NE	0.8956
Woodbury, IA	
Dakota, NE	
7760 Sioux Falls, SD	0.9271
Lincoln, SD	
Minnehaha, SD	
7800 South Bend, IN	0.9782
St. Joseph, IN	
7840 Spokane, WA	1.0857
Spokane, WA	
7880 Springfield, IL	0.8908
Menard, IL	
Sangamon, IL	
7920 Springfield, MO	0.8423
Christian, MO	
Greene, MO	
Webster, MO	
8003 Springfield, MA	1.0419
Hampden, MA	
Hampshire, MA	
8050 State College, PA	0.8705
Centre, PA	
8080 Steubenville-Weirton, OH-WV	0.8364
Jefferson, OH	
Brooke, WV	
Hancock, WV	
8120 Stockton-Lodi, CA	1.0362
San Joaquin, CA	
8140 Sumter, SC	0.8210
Sumter, SC	
8160 Syracuse, NY	0.9374
Cayuga, NY	
Madison, NY	
Onondaga, NY	
Oswego, NY	
8200 Tacoma, WA	1.1071
Pierce, WA	
8240 Tallahassee, FL	0.8485
Gadsden, FL	
Leon, FL	
8280 Tampa-St. Petersburg-Clearwater, FL	0.9066
Hernando, FL	
Hillsborough, FL	
Pasco, FL	
Pinellas, FL	
8320 Terre Haute, IN	0.8292
Clay, IN	
Vermillion, IN	
Vigo, IN	
8360 Texarkana, AR-Texarkana, TX	0.8117
Miller, AR	
Bowie, TX	
8400 Toledo, OH	0.9343
Fulton, OH	
Lucas, OH	
Wood, OH	
8440 Topeka, KS	0.9071
Shawnee, KS	
8480 Trenton, NJ	1.0474
Mercer, NJ	
8520 Tucson, AZ	0.8945
Pima, AZ	
8560 Tulsa, OK	0.9148
Creek, OK	
Osage, OK	
Rogers, OK	
Tulsa, OK	
Wagoner, OK	
8600 Tuscaloosa, AL	0.8179
Tuscaloosa, AL	
8640 Tyler, TX	0.9366
Smith, TX	
8680 Utica-Rome, NY	0.8369
Herkimer, NY	
Oneida, NY	
8720 Vallejo-Fairfield-Napa, CA	1.3323
Napa, CA	
Solano, CA	
8735 Ventura, CA	1.1019
Ventura, CA	
8750 Victoria, TX	0.8151
Victoria, TX	
8760 Vineland-Millville-Bridgeton, NJ	1.0363
Cumberland, NJ	
8780 Visalia-Tulare-Porterville, CA	0.9755
Tulare, CA	
8800 Waco, TX	0.8360
McLennan, TX	
8840 Washington, DC-MD-VA-WV	1.0860
District of Columbia, DC	
Calvert, MD	
Charles, MD	
Frederick, MD	
Montgomery, MD	
Prince Georges, MD	
Alexandria City, VA	
Arlington, VA	
Clarke, VA	
Culpepper, VA	
Fairfax, VA	
Fairfax City, VA	
Falls Church City, VA	
Fauquier, VA	
Fredericksburg City, VA	
King George, VA	
Loudoun, VA	
Manassas City, VA	
Manassas Park City, VA	
Prince William, VA	
Spotsylvania, VA	
Stafford, VA	
Warren, VA	
Berkeley, WV	
Jefferson, WV	
8920 Waterloo-Cedar Falls, IA	0.8332
Black Hawk, IA	
8940 Wausau, WI	0.9653
Marathon, WI	

TABLE 7.—WAGE INDEX FOR URBAN AREAS—Continued

Urban area (constituent counties or county equivalents)	Wage index
8960 West Palm Beach-Boca Raton, FL	0.9759
Palm Beach, FL	
9000 Wheeling, OH-WV	0.7464
Belmont, OH	
Marshall, WV	
Ohio, WV	
9040 Wichita, KS	0.9200
Butler, KS	
Harvey, KS	
Sedgwick, KS	
9080 Wichita Falls, TX	0.8307
Archer, TX	
Wichita, TX	
9140 Williamsport, PA	0.8125
Lycoming, PA	
9160 Wilmington-Newark, DE-MD	1.0838
New Castle, DE	
Cecil, MD	
9200 Wilmington, NC	0.9524
New Hanover, NC	
Brunswick, NC	
9260 Yakima, WA	1.0330
Yakima, WA	
9270 Yolo, CA	0.9167
Yolo, CA	
9280 York, PA	0.9082
York, PA	
9320 Youngstown-Warren, OH	0.9176
Columbiana, OH	
Mahoning, OH	
Trumbull, OH	
9340 Yuba City, CA	1.0155
Sutter, CA	
Yuba, CA	
9360 Yuma, AZ	0.8859
Yuma, AZ	

TABLE 8.—WAGE INDEX FOR RURAL AREAS

Rural area	Wage index
Alabama	0.7461
Alaska	1.1838
Arizona	0.9233
Arkansas	0.7703
California	0.9987
Colorado	0.9291
Connecticut	1.2134
Delaware	0.9518
Florida	0.8834
Georgia	0.8560
Guam	0.9611
Hawaii	0.9918
Idaho	0.8937
Illinois	0.8221
Indiana	0.8788
Iowa	0.8382
Kansas	0.8002
Kentucky	0.7941
Louisiana	0.7428
Maine	0.8776
Maryland	0.9088
Massachusetts	1.0390
Michigan	0.8848
Minnesota	0.9293
Mississippi	0.7747
Missouri	0.7860
Montana	0.8765
Nebraska	0.8787
Nevada	0.9767
New Hampshire	0.9989
New Jersey [1]	....
New Mexico	0.8236
New York	0.8491
North Carolina	0.8424
North Dakota	0.7746
Ohio	0.8784
Oklahoma	0.7506
Oregon	0.9953
Pennsylvania	0.8344
Puerto Rico	0.4002
Rhode Island [1]	....
South Carolina	0.8464
South Dakota	0.8162
Tennessee	0.7854
Texas	0.7748
Utah	0.8937
Vermont	0.9269
Virginia	0.8464
Virgin Islands	0.7166
Washington	1.0346
West Virginia	0.7986
Wisconsin	0.9266
Wyoming	0.9073

[1] All counties within the State are classified urban.

D. Publication of Updates to the Federal Rates

In accordance with section 1888(e)(4)(E) of the Act, the final payment rates listed here reflect an update equal to the full SNF market basket, which equals 3.0 percent. In addition, the FY 2004 rates will be adjusted by an additional 3.26 percent to reflect the cumulative forecast error since the start of the SNF PPS on July 1, 1998. We will continue to publish the rates, wage index, and case-mix classification methodology in the **Federal Register** before August 1 preceding the start of each succeeding fiscal year. Along with a number of other revisions discussed elsewhere in this preamble, this final rule provides the annual updates to the Federal rates as mandated by the Act.

E. Relationship of RUG–III Classification System to Existing SNF Level-of-Care Criteria

As discussed in § 413.345, we include in each update of the Federal payment rates in the **Federal Register** the designation of those specific RUGs under the classification system that represent the required SNF level of care, as provided in § 409.30. This designation reflects an administrative presumption under the current 44-group RUG–III classification system. Our presumption is that any beneficiary who is correctly assigned to one of the upper 26 RUG–III groups in the initial 5-day, Medicare-required assessment is automatically classified as meeting the SNF level of care definition up to the assessment reference date (ARD) for that assessment.

Any beneficiary assigned to any of the lower 18 groups is not automatically classified as either meeting or not meeting the definition, but instead receives an individual level of care determination using the existing administrative criteria. This presumption recognizes the strong likelihood that beneficiaries assigned to one of the upper 26 groups during the immediate post-hospital period require a covered level of care, which would be significantly less likely for those beneficiaries assigned to one of the lower 18 groups.

In this final rule, we are continuing the existing designation of the upper 26 RUG–III groups for purposes of this administrative presumption. Accordingly, we are designating the following RUG–III classifications:

- All groups within the Ultra High Rehabilitation category;
- All groups within the Very High Rehabilitation category;
- All groups within the High Rehabilitation category;
- All groups within the Medium Rehabilitation category;
- All groups within the Low Rehabilitation category;
- All groups within the Extensive Services category;
- All groups within the Special Care category; and
- All groups within the Clinically Complex category.

Comment: One commenter supported the continuation of our presumption policy based on accurate classification into one of the upper 26 RUG–III groups.

Response: We agree that this policy should be retained.

F. Expiration of Initial Three-Year Transition Period

As noted previously in sections I.A and I.E.2 of this final rule, the initial three-year transition period from facility-specific to Federal rates under the SNF PPS has expired. Therefore, payment now equals 100 percent of the adjusted Federal per diem rate.

G. Example of Computation of Adjusted PPS Rates and SNF Payment

Using the XYZ SNF described in Table 9, the following shows the adjustments made to the Federal per diem rate to compute the provider's actual per diem PPS payment. XYZ's 12-month cost reporting period begins October 1, 2004. XYZ's total PPS payment would equal $20,379. The Labor and Non-labor columns are derived from Table 5. In addition, the adjustments for certain specified RUG–III groups enacted in section 101(a) of the BBRA (as amended by section 314 of the BIPA) remain in effect, and are reflected in Table 9.

TABLE 9.—SNF XYZ: LOCATED IN STATE COLLEGE, PA

[Wage Index: 0.8705]

RUG group	Labor	Wage index	Adj. labor	Non-labor	Adj. rate	Percent adjustment	Medicare days	Payment
RVC	$268.21	0.8705	$233.48	$82.98	$316.46	$337.66*	14	$4,727
RHA	207.28	0.8705	180.44	64.13	244.57	260.96*	16	4,175
SSC	172.65	0.8705	150.29	53.41	203.70	244.44**	30	7,333
IA2	117.07	0.8705	101.91	36.22	138.13	138.13	30	4,144
Total							90	20,379

* Reflects a 6.7 percent adjustment from section 314 of the BIPA.
** Reflects a 20 percent adjustment from section 101(a) of the BBRA.

H. SNF Market Basket Index

1. Background

Section 1888(e)(5)(A) of the Act requires us to establish a SNF market basket index (input price index) that reflects changes over time in the prices of an appropriate mix of goods and services included in the SNF PPS. This final rule incorporates the latest available projections of the SNF market basket index. Accordingly, we have developed a SNF market basket index that encompasses the most commonly used cost categories for SNF routine services, ancillary services, and capital-related expenses. In the July 31, 2001 **Federal Register** (66 FR 39562), we included a complete discussion on the rebasing of the SNF market basket to FY 1997. There are 21 separate cost categories and respective price proxies. These cost categories were illustrated in Table 10.A, Table 10.B, and Appendix A, along with other relevant information, in the July 31, 2001 **Federal Register**.

Each year, we calculate a revised labor-related share based on the relative importance of labor-related cost categories in the input price index. Table 10 summarizes the updated labor-related share for FY 2004.

TABLE 10.—FY 2004 LABOR-RELATED SHARE

Cost category	FY 2003 Relative importance	FY 2004 Relative importance
Wages and Salaries	54.796	55.115
Employee Benefits	11.232	11.304
Nonmedical Professional Fees	2.652	2.651
Labor-Intensive Services	4.124	4.130
Capital-Related	3.324	3.172
Total	76.128	76.372

Source: (Table 10) Global Insights, Inc., DRI–WEFA, 4th Quarter, 2002.

2. Use of the SNF Market Basket Percentage

Section 1888(e)(5)(B) of the Act defines the SNF market basket percentage as the percentage change in the SNF market basket index, as described in the previous section, from the average index level of the prior fiscal year to the average index level of the current fiscal year. For the Federal rates established in this final rule, this percentage increase in the SNF market basket index is used to compute the update factor occurring between FY 2003 and FY 2004. We used the Global Insights, Inc. (formerly DRI–WEFA), 4th quarter 2002 forecasted percentage increase in the FY 1997-based SNF market basket index for routine, ancillary, and capital-related expenses, described in the previous section, to compute the update factor.

3. Market Basket Forecast Error Adjustment

In the supplemental proposed rule, we discussed the possibility of developing a market basket forecast adjustment to the rates. We solicited comments on—

- The appropriateness of making a cumulative market basket forecast adjustment reflecting underforecasts since the start of the SNF PPS;
- The continued use of this forecast error adjustment in future rate years;
- The appropriateness of applying a threshold to these annual rate adjustments; and
- Ways that we could use our authority to encourage industry innovation and monitor efforts to further promote quality improvement efforts among SNFs (see section III.L).

4. Federal Rate Update Factor

Section 1888(e)(4)(E)(ii)(IV) of the Act requires that the update factor used to establish the FY 2004 Federal rates be at a level equal to the full market basket percentage change. Accordingly, to establish the update factor, we determined the total growth from the average market basket level for the period of October 1, 2002 through September 30, 2003 to the average market basket level for the period of October 1, 2003 through September 30, 2004. Using this process, the market basket update factor for FY 2004 SNF Federal rates is 3.0 percent. In addition, as noted in the comments and responses shown below, the rates were adjusted by 3.26 percent to reflect the difference between the market basket forecast and the actual market basket increase from the start of the SNF PPS in July 1998.

We used this revised update factor to compute the Federal portion of the SNF PPS rate shown in Tables 1 and 2.

Comment: The majority of commenters strongly supported the proposed rule's provision for a full market basket adjustment for FY 2004. However, a few commenters cited a MedPAC analysis indicating that an across-the-board update may not be appropriate. These commenters recommended either a zero update or an update targeted to specific types of providers, such as hospital-based SNFs.

Response: We are required by statute to implement a full market basket adjustment for FY 2004. In the proposed rule, we published a preliminary market basket factor of 2.9 percent, based on the Global Insights Inc., DRI-WEFA, 4th Quarter, 2002 update. For this final rule, we are using an updated market basket forecast amount of 3.0 percent, based on the Global Insights Inc., DRI-WEFA, 2nd Quarter, 2003 update, which is the most recent data available.

Comment: The vast majority of commenters supported our proposal in the supplemental proposed rule to incorporate a market basket forecast error adjustment into the SNF PPS rate-setting system. These commenters urged us to implement the 3.26 percent cumulative market basket adjustment for the FY 2004 rates. They indicated that the cumulative adjustment is a necessary stabilizing factor, and reflects actual market conditions. A few commenters questioned the necessity of this cumulative adjustment, and suggested that the money could be used more effectively if targeted to specific programs. However, all commenters agreed that, if we proceeded with the cumulative market basket forecast error adjustment, we should apply the forecast error adjustment in subsequent rate years, even in situations where an overstatement of the forecasted market basket adjustment could result in a later downward adjustment.

Response: We carefully considered the implications of adopting this market basket forecast error adjustment. We concluded that, in making the 3.26 percent adjustment, we are not providing a source of new industry funding. Instead, we are correcting an underforecast of pricing levels that resulted in lower payments than we would otherwise have made if actual, instead of forecast, data were used. To a great extent, this underforecast reflects the faster-than-expected growth in wages and benefits for nursing home workers since the start of the SNF PPS, as a result of continued rapid growth in the health sector and the shortage of nurses. As a result of these market conditions, SNFs have already incurred expenses at a higher-than-forecasted level. Our overarching Medicare integrity goal is to pay the appropriate amount, to the correct provider, for the proper service, at the right time. Adjusting for this difference between the forecasted and actual market basket values is consistent with that goal. Therefore, we will implement the 3.26 percent cumulative adjustment for FY 2004. For future years, as actual market basket data become available, we will apply the forecast error adjustment to subsequent rate years. As explained in our supplemental proposed rule, this annual adjustment will be applied on a two-year lag basis (that is, the time period for obtaining final market basket data), and will reflect both upward and downward adjustments, as appropriate.

Comment: Several commenters expressed concern about the proposed use of a 0.25 percentage point threshold for application of the annual forecast adjustments. Some commenters maintained that every forecast error, however small, should be corrected, and that the use of a threshold would build over time, resulting in increasing inaccuracies in the rates. Other commenters said that the adjustment should be meaningful, and that the 0.25 percent threshold was consistent with similar CMS rate-setting provisions. A few commenters suggested increasing the threshold.

Response: In the supplemental proposed rule, we discussed establishing an adjustment for forecast error that would take account annually a forecast error that was at least 0.25 percentage points above or below the actual market basket performance. For the capital PPS update and in the hospital PPS update framework, a forecast error adjustment is reflected only when the forecast and actual market basket percent changes differ by more than 0.25 percentage points. To apply this methodology to the SNF PPS would follow an established practice. In addition, our experience with those PPS frameworks suggests that the forecast errors are relatively small, and generally clustered around zero, so we do not anticipate an accumulation that would significantly affect the rates over time. We are more concerned that the forecast error in any given year is large enough that the SNF PPS base payment rate does not adequately reflect the historical price changes faced by SNFs. Therefore, we will use the 0.25 percentage point threshold to determine whether a forecast error adjustment is appropriate.

Comment: A few commenters expressed concern about the market basket and its methodology and urged us to institute a thorough review of all of the weight and price proxy components in the market basket, particularly wages, capital, and malpractice insurance. These commenters proposed a collaborative effort between the Federal government and private industry to review the market basket methodology.

Response: We agree that it is important to review the market basket weights and price proxies regularly to ensure that they adequately reflect the requirements of section 1888(e)(5) of the Act. It has always been our policy to regularly revise and update the market basket when appropriate, and we did so most recently in 2001, when we rebased the market basket to reflect 1997 cost data. In addition, we have discussed issues related to the market basket with interested parties since the implementation of the SNF PPS, and continue to do so in order to have a technically and conceptually sound market basket that satisfies the legislative requirement explained in section 1888(e)(5) of the Act.

In the July 31, 2001 final rule introducing the 1997-based market basket, we fully explained our criteria for choosing price proxies for market basket cost categories. We use four criteria for this process: timeliness (published and available on a regular basis, preferably at least quarterly, with little lag), reliability (consistent historical time-series as well as being technically and methodologically sound), representativeness (reflecting or proxying actual provider experience), and relevance (holding non-price factors constant, such as skill mix and quality shifts). The current price proxy for wages and salaries, the Employment Cost Index (ECI) for nursing home workers, meets all four of these criteria. We believe that the ECI better meets our criteria than the two other government statistics for nursing home wages, the Average Hourly Earnings (AHE) for nonsupervisory workers in nursing homes and the Employer Cost for Employee Compensation (ECEC) for workers in nursing homes. Although the ECI represents total nursing home wages and salaries, SNFs comprise over 75 percent both of employment and payroll totals for the nursing home industry and, with this representation, SNF wages and salaries are the drivers for changes in the ECI for nursing home wages and salaries. Thus, given available data, we continue to believe that the ECI for nursing home workers is the most appropriate price proxy for growth in wages in SNFs, and we will continue to use it in the SNF market basket. It should be noted that the use of this wage proxy should not be confused with the forecast error correction, which is only the difference between the actual and forecasted percent change in the ''same'' market basket.

These commenters disagreed with the use of the average yield for AAA bonds as the price proxy for interest costs of for-profit nursing homes, rather than the average yield for BAA or lower rated bonds. In the SNF market basket, the change in the average yield for AAA bonds is used in calculating the SNF market basket price change of the debt held by for-profit SNFs. The amount of the bonds issued, the average term of these bonds, and the mix of bond ratings issued should all be held constant in a fixed-weight Laspeyres price index, such as the SNF market basket. The price change of interest costs associated with corporate bonds should reflect the change in interest rates (yield) for the mix of differently rated corporate bonds held in the base period. Our price proxy should represent the change in the interest rates associated with this fixed mix.

We have conducted sensitivity analyses of the market basket using the change in the yield for different bond ratings, and the change in the long-run yields of AAA, AA, A, and BAA bonds were all very similar. The use of any of these bond yields would produce essentially similar results. For simplicity, both in the maintenance of the index and in the availability of forecasted data, we have chosen to use Moody's AAA corporate bonds. Had we used BAA corporate bonds, the resulting SNF market basket increases would have been identical.

We believe that the current method for reflecting corporate bond prices in the SNF market basket is appropriate because it keeps the mix of corporate bonds issued constant at the base period proportions and captures the associated price change in this mix without having to reflect the rating on each separately issued bond, since they move similarly over time. While we understand the commenter's concern, our research and analysis indicate that our method of accounting for change in bond prices for for-profit SNFs in the market basket is appropriate.

These commenters noted that the current price proxies for interest costs do not reflect the short-term nature of the debt funding currently available to the industry or the fluctuations in rate changes in the leasing marketplace. These are important issues and we will continue to conduct the necessary research on these topics to ensure that they are adequately considered in the market basket. Since we currently use a similar debt life for SNFs and hospitals when vintage weighting the capital components of the market basket, a movement towards shorter average debt terms for SNFs should be considered. (Vintage weighting is the process of weighting together the price changes of current and prior capital purchases (or debt held) based on the average historical acquisition pattern over the useful life of the asset or debt instrument.) We will review available data sources on this information and make a change if appropriate. While we currently believe that leasing costs are appropriately accounted for in the market basket, we will also review this issue more fully to ensure that this is both theoretically and empirically the case.

When we rebased the SNF market basket in 2001, we reviewed Medicare cost report data on professional liability insurance, and found that the vast majority of SNFs did not enter their data into this section of the cost reports (only about 20 SNFs provided that information in 1997). We also looked at Department of Commerce Input-Output data for 1997, and found that insurance was less than 0.2 percent of total SNF expenses. Because the SNF market basket is currently based on the cost structure facing SNFs in 1997, it appears that professional liability costs are a very small portion of total costs and, thus, would likely not have a significant impact on the market basket percentage change. However, we also understand the emerging importance of this issue to SNFs and will continue to review the Medicare cost report data, as well as any other data sources that commenters can recommend to us that would meet our criteria, with the hope that we may possibly incorporate this information into the market basket structure when appropriate.

Comment: A commenter stated that we should reconsider the necessity of a two-year forecast error correction lag if, over time, data become available on a more timely basis.

Response: It is our policy when determining the forecast error correction to use the most recent data available. Currently, this would mean a two-year lag on the correction is necessary, since historical data for the current fiscal year are not available until after the following year's update is determined. Should the data become available on a quicker basis, we would investigate the continued need for a two-year lag. However, a change in availability of data is unlikely, since these data (primarily from Federal government databases) are published on pre-determined schedules. Producer Price Indices (PPI), for instance, are not final until five months after the reference month, and Employment Cost Indices (ECI) only become available in the quarter following the reference quarter. Based on these schedules, for example, a determination of the actual market basket change for FY 2004 would not be available until March 2005. Therefore, it would be impossible to incorporate this information any earlier than the FY 2006 update, creating an unavoidable two-year lag.

I. Consolidated Billing

As established by section 4432(b) of the BBA, the consolidated billing requirement places with the SNF the Medicare billing responsibility for virtually all of the services that the SNF's residents receive, except for a small number of services that the statute specifically identifies as being excluded from this provision. Section 103 of the BBRA amended this provision by further excluding a number of high-cost, low probability services (identified by Healthcare Common Procedure Coding System (HCPCS) codes) within several broader categories that otherwise remained subject to the provision. Section 313 of the BIPA further amended this provision by repealing its Part B aspect, that is, its applicability to services furnished to a resident during a SNF stay that Medicare does not cover. (However, physical, occupational, and speech-language therapy remain subject to consolidated billing, regardless of whether the resident who receives these services is in a covered Part A stay.) In addition, section 313 of the BIPA specified that consolidated billing applies only to services furnished to those individuals residing in an institution (or portion of an institution) that is actually certified by Medicare as a SNF.

To date, the Congress has enacted no further legislation affecting the consolidated billing provision. However, as we noted in the April 10, 2000 proposed rule (65 FR 19232), section 1888(e)(2)(A)(iii) of the Act, as added by section 103 of the BBRA, not only identified for exclusion from this provision a number of particular service codes within four specified categories (that is, chemotherapy items, chemotherapy administration services, radioisotope services, and customized prosthetic devices), but ''* * * also gives the Secretary the authority to designate additional, individual services for exclusion within each of the specified service categories.'' In the FY 2001 proposed rule, we also noted that the BBRA Conference Report (H.R. Conf.

Rep. No. 106–479 at 854) characterizes the individual services that this legislation targets for exclusion as ''* * * high-cost, low probability events that could have devastating financial impacts because their costs far exceed the payment [SNFs] receive under the prospective payment system * * *.'' According to the conferees, section 103(a) ''is an attempt to exclude from the PPS certain services and costly items that are provided infrequently in SNFs * * *.'' By contrast, we noted that the Congress declined to designate for exclusion any of the remaining services within those four categories (thus leaving all of those services subject to SNF consolidated billing), because they are relatively inexpensive and are furnished routinely in SNFs.

As we further explained in the July 31, 2000 final rule (65 FR 46790), any additional service codes that we might designate for exclusion under our discretionary authority must meet the same criteria that the Congress used in identifying the original codes excluded from consolidated billing under section 103(a) of the BBRA: they must fall within one of the four service categories specified in the BBRA, and they also must meet the same standards of high cost and low probability in the SNF setting. Accordingly, we characterized this statutory authority to identify additional service codes for exclusion ''* * * as essentially affording the flexibility to revise the list of excluded codes in response to changes of major significance that may occur over time (for example, the development of new medical technologies or other advances in the state of medical practice)'' (65 FR 46791). In view of the amount of time that has elapsed since we made that statement, we invited public comments in the May 16, 2003 proposed rule (68 FR 26776) on codes in any of these four service categories which represent recent medical advances that might meet the BBRA criteria for exclusion from SNF consolidated billing.

Comment: Although the proposed rule specifically invited comments on possible exclusions within the specific service categories identified in the BBRA legislation, a number of commenters took this opportunity to reiterate concerns about other aspects of consolidated billing. For example, we received a number of comments concerning the possible exclusion of additional categories of services from SNF consolidated billing, beyond those specified in the BBRA. The commenters identified services such as modified barium swallows, stress tests, hyperbaric oxygen treatments, doppler studies, and nuclear medicine scans as appropriate candidates for exclusion. In addition, a number of commenters recommended a further set of services for exclusion. These additional services are durable medical equipment (including, but not limited to, ventilators, speech devices, specialty beds, wheelchairs, wound care devices and diabetic shoes), antibiotics, TPN, and diagnostic tests.

Response: As enacted by section 4432(b) of the BBA, the original set of consolidated billing exclusions at section 1888(e)(2)(A)(ii) of the Act broadly excluded entire categories of services from consolidated billing (primarily, those of physicians and certain other types of medical practitioners). By contrast, the set of statutory exclusions at section 1888(e)(2)(A)(iii) of the Act, as subsequently enacted by section 103 of the BBRA, was more specifically targeted within a number of broader service categories. In the proposed rule, we noted that the original BBRA legislation (as well as the implementing regulations) provides the Secretary the authority to designate additional, individual services for exclusion within each of the BBRA-specified service categories. However, the statute does not provide the Secretary the authority to create additional categories of excluded services beyond those specified in the law. Therefore, based on the statute, we cannot exclude services and items from consolidated billing unless they fall into the categories of services provided in the statute and addressed in the BBRA.

Comment: Several commenters recommended that we exclude a variety of additional chemotherapy agents and radioisotopes used for cancer treatment. One commenter specifically recommended that we exclude Zevalin which is used in the treatment of non-Hodgkins lymphoma.

Response: The BBRA specified that certain chemotherapy drugs and radioisotope services (sections 1888(e)(2)(A)(iii)(II) and (IV) of the Act) be excluded from the SNF PPS payments. Specific chemotherapy drugs and radioisotope services were then identified by HCPCS code in the statute. The BBRA authorized us to update the list of excluded services to reflect advances in technology and medical practice.

We note that most of the chemotherapy drugs and radioisotope services mentioned by commenters were considered for exclusion under the BBRA, but were not adopted by the Congress in the BBRA list of excluded items and services.

However, we did identify a new radiopharmaceutical (that is, radiotherapeutic substance linked to a radioisotope administered to deliver therapeutic radioactivity), Zevalin, which combines elements of both the chemotherapy and radioisotope categories excluded under the BBRA. This radiopharmaceutical links monoclonal antibodies with a radioisotope. In the case of Zevalin, the monoclonal antibody it uses is a chemotherapy drug that is already excluded from the SNF PPS payments. In addition, the Food and Drug Administration (FDA) has recently approved Bexxar, a radiopharmaceutical equivalent to Zevalin. We believe that these two radiopharmaceutical agents meet the criteria that were used to create the original lists of items to be excluded, because they are high-cost services that are unlikely to be used in the SNF setting, and that could not have been reflected in the base year costs for the SNF PPS (since neither of these products were available at that time).

Accordingly, we will add Zevalin (HCPCS codes A9522 and A9523) and Bexxar (HCPCS code not yet available) to the list of items excluded from consolidated billing. These exclusions will appear in the Consolidated Billing Annual Update Program Memorandum that we will issue at the end of CY 2003, and will be effective as of January 1, 2004.

In excluding the additional services from consolidated billing and the SNF PPS (and, thus, qualifying them for separate payment under Part B), section 103 of the BBRA also mandated a corresponding proportional reduction in Part A SNF payments, beginning with FY 2001. Specifically, section 1888(e)(4)(G)(iii) of the Act provides that the Secretary ''* * * shall provide for an appropriate proportional reduction in payments'' so that the *aggregate* reduction in Part A payments is equal to the *aggregate* increase in Part B payments attributable to the exclusions provided under section 1888(e)(2)(A)(iii) of the Act. This requirement applies not only to the original legislation, but to the BBRA-authorized update process. Thus, the actual result of this provision's mandatory Part A payment reduction is to take the expense of the excluded items (which could be financially devastating to an individual SNF that actually incurs it, if borne solely by that particular facility) and effectively redistribute it over the entire universe of providers. As we noted in the July 31, 2000 final rule (65 FR 46792), in much the same way that an insurance pool reduces the degree of financial risk to an individual member of the pool in the event of a catastrophic loss, effectively spreading the expense of the excluded items over such a large provider population helps minimize the potential financial liability that any individual provider might otherwise incur.

The consolidated billing exclusions addressed under the BBRA were items and services that had been in use for many years. We had data for the SNF PPS base year that were used to determine utilization of these services and make the appropriate adjustment. In our July 31, 2001 final rule, we implemented a $.05 reduction in the SNF PPS rate to reflect this proportional adjustment.

The situation is slightly different when applied to these new consolidated billing exclusions. Since these two radiopharmaceuticals were not in existence during the SNF PPS base year, we cannot rely on historical utilization data to develop an appropriate reduction. In addition, as a new class of treatment, there may not be a relationship between the use of these radiopharmaceuticals and the use of other chemotherapy agents or radioisotopes used during the SNF PPS base year.

In light of these considerations, we have developed the following approach. We estimate the combined utilization of these two radiopharmaceuticals to be approximately 25 doses per year, which most closely equates to a $.01 reduction to the unadjusted urban and rural SNF PPS per diem rates to reflect the FY 2004 revision of the consolidated billing exclusions. (For comparison purposes, as stated above, the offset used to adjust for the complete list of BBRA exclusions was a negative $.05 adjustment.) Once we have collected actual utilization data on the use of these new radiopharmaceuticals (as well as on changes in utilization in other chemotherapy and radioisotope agents), we will reassess whether the $.01 offset most accurately represents an ''appropriate proportional reduction'' in Part A SNF payments under section 1888(e)(4)(G)(iii) of the Act, and will make any appropriate adjustments in the amount of that offset. This aggregate adjustment could involve either an increase or decrease in the interim $.01 offset amount applied for FY 2004, in order to ensure that the final adjustment most accurately reflects the ''appropriate proportional reduction'' required under section 1888(e)(4)(G)(iii) of the Act.

Comment: Some commenters cited the existing list of exclusions (in § 411.15(p)(3)(iii)) for certain high-intensity outpatient hospital services, and expressed the view that these exclusions should not be limited to only those services that actually require the intensity of a hospital setting, but rather, should also encompass services furnished in other, nonhospital settings as well. As an example, they cited services such as magnetic resonance imaging (MRIs) furnished in freestanding imaging centers and radiation therapy furnished in freestanding oncology centers, both of which may be cheaper and more accessible in certain particular localities than those furnished by hospitals.

Response: As we noted in the May 12, 1998 interim final rule (63 FR 26298), and again in the July 31, 2000 final rule (65 FR 46790 through 46791), the exclusion of certain outpatient hospital services (in § 411.15(p)(3)(iii)) is targeted specifically at those services ''* * * that, under commonly accepted standards of medical practice, lie *exclusively* within the purview of hospitals * * *'' (emphasis added); that is, services which generally require the intensity of the hospital setting in order to be furnished safely and effectively. Basically, we determined that this high level of outpatient hospital care is beyond the scope of SNF comprehensive care plans and should be excluded from consolidated billing. The intensive outpatient hospital services identified under this exclusion were not subject to consolidated billing. However, this exclusion does not encompass services furnished in any other health care setting. Thus, to the extent that advances in medical practice over time may make it feasible to perform such a service more widely in a less intensive, nonhospital setting, this would not argue in favor of unbundling the nonhospital performance of the service under these regulations, but rather, of considering whether to rebundle the service entirely back to the SNF. In addition, we note that unlike the outpatient hospital exclusions in § 411.15(p)(3)(iii), the statutory exclusions enacted by the BBRA for certain chemotherapy and other services apply regardless of the setting (hospital versus freestanding) in which the services are furnished. Adding services such as MRIs and radiation therapy to the existing statutory list of exclusions would require legislation by the Congress to amend the law itself.

Comment: One commenter requested the exclusion of specific speech-language pathology evaluations and treatments.

Response: As we noted in the FY 2002 proposed rule (66 FR 24020), we regard the provision of therapy services as an inherent and integral function of an SNF, and we believe that the statutory provisions on consolidated billing clearly reflect this position. Section 1888(e)(2)(A)(ii) of the Act provides that physical, occupational, and speech-language therapy services are subject to consolidated billing, even when performed by a type of practitioner (for example, a physician) whose services would otherwise be excluded. In addition, section 1862(a)(18) of the Act specifies that consolidated billing applies to these services when furnished to *any* resident of an SNF, even if Part A does not cover the resident's stay. Accordingly, all physical, occupational, and speech-language therapy services furnished to SNF residents are subject to consolidated billing, and any changes to this aspect of the provision would require legislation by the Congress to amend the law.

Comment: Several commenters also proposed expanding the list of excluded services by redefining categories of service that are currently excluded from consolidated billing. For example, while the BBRA excludes specific chemotherapy services by HCPCS codes, these commenters recommended not only adding to the list of excluded chemotherapy pharmaceuticals, but expanding the exclusion to encompass all related services associated with a chemotherapy treatment, such as supplies and other pharmaceuticals used to treat side effects. In addition, several commenters recommended exclusion of oral chemotherapy agents that are not separately billable to Medicare Part B for any beneficiary, and are currently covered only as part of the overall package of services furnished under the Part A inpatient hospital or SNF benefits.

Response: In the proposed rule, we noted that the BBRA's list of services excluded by HCPCS code is a targeted list, narrowly carving out only certain individual ''high-cost, low probability'' services *within* a number of broader service categories—such as chemotherapy services—that otherwise remained subject to consolidated billing. As we noted in the proposed rule (68 FR 26776), the BBRA provides the Secretary the authority to designate additional, individual services for exclusion within each of the service categories that it specifies. However, the statute does not provide authority to exclude other services that, while related, fall outside of the specified service categories themselves. For example, although anti-nausea drugs are commonly used *in conjunction with* chemotherapy, they are not in themselves chemotherapeutic agents and, consequently, do not fall within one of the excluded categories designated in the BBRA. Further, we believe that the Congress was clear in its intent regarding the particular items and services to be excluded from consolidated billing, by use of the HCPCS codes specified in the Act. Regarding the suggestion to exclude from consolidated billing those oral chemotherapy agents that are not separately billable to Part B (and are currently covered only under the Part A inpatient hospital and SNF benefits), we note that expanding the existing drug coverage available under Part B to include those drugs is not within our authority. Implementing this change would require legislation by the Congress to amend the law.

We note that some chemotherapy pharmaceuticals that commenters proposed for exclusion have already been included in the list of HCPCS codes excluded from the consolidated billing provisions. The most recent annual update regarding HCPCS exclusions from consolidating billing can be found in Program Memorandum A–02–118 (Change Request (CR) #2459), published November 8, 2002.

Comment: Two commenters requested an expansion of the dialysis exclusion to encompass dialysis services furnished directly by the SNF. In addition, several commenters noted that erythropoietin (EPO) currently is excluded from consolidated billing only when furnished in conjunction with the Part B dialysis benefit, and they recommended expanding this exclusion to encompass its use in connection with other, non-dialysis forms of treatment (such as chemotherapy).

Response: Under section 1888(e)(2)(A)(ii) of the Act, the exclusion of dialysis services from consolidated billing applies only to those services that meet the requirements for coverage under the separate Part B dialysis benefit at section 1861(s)(2)(F) of the Act. The Part B benefit allows for home dialysis and dialysis performed on the premises of a certified dialysis facility. By contrast, if the SNF itself elects to furnish dialysis services to a resident during a covered Part A stay (either directly with its own resources, or under an ''arrangement'' with a certified dialysis facility in which the SNF itself does the billing), the services are no longer considered Part B dialysis services, but rather, are Part A SNF services. Accordingly, they would no longer qualify for the statutory exclusion of Part B dialysis services from consolidated billing, and would instead be bundled into the comprehensive PPS per diem payment that the SNF receives for the package of services that it furnishes during the resident's covered Part A stay. Any change in the scope of the dialysis exclusion from consolidated billing would require legislation by the Congress to amend the law. We note that we are proactively monitoring the impact of the SNF PPS to ensure that beneficiary access is not compromised. To that end, we have requested that the Office of the Inspector General (OIG) specifically examine the effect of the PPS on SNF residents' access to dialysis treatment. We will continue to gather extensive information from around the country with respect to SNF PPS implementation and will look to a variety of sources for objective information and evidence of the impact of this policy on access to quality care.

Similarly, under section 1888(e)(2)(A)(ii) of the Act, the exclusion of EPO from consolidated billing applies only to those services that meet the requirements for coverage under the separate Part B EPO benefit at section 1861(s)(2)(O) of the Act. Section 1861(s)(2)(O) of the Act permits coverage of EPO and items related to its administration for those dialysis patients who can self-administer the drug, subject to methods and standards established by the Secretary for its safe and effective use (as described in § 405.2163(g) and (h)). Since EPO that is used for non-dialysis patients does not fall within the scope of section 1861(s)(2)(O) of the Act, that usage does not fall within the scope of the EPO exclusion from consolidated billing.

Comment: One commenter requested that we ''develop a system to eliminate the billing of SNFs for extraneous physician visits.''

Response: Under section 1888(e)(2)(A)(ii) of the Act and § 411.15(p)(2)(i) of the regulations, physician services that meet the criteria for payment on a fee schedule basis are excluded from consolidated billing and, accordingly, can already be billed directly to the Part B carrier by physicians themselves.

Comment: A few commenters recommended expanding the consolidated billing exclusions to provide short-term relief pending the implementation of SNF PPS refinements. They urged this course of action as a way of ensuring continued access to SNF care for beneficiaries with heavy non-therapy ancillary needs.

Response: We agree that the SNF PPS needs to identify more accurately those beneficiaries with high pharmaceutical and other non-therapy ancillary needs, and we are actively conducting research designed to address these issues. However, we do not have the authority, nor do we believe it is appropriate, to expand the consolidated billing exclusions as a substitute for actual refinements. As we noted in the July 31, 2001 final rule (66 FR 39588) in response to similar comments,

> * * * we do not share the view of those commenters who suggested that the creation of additional exclusions from consolidated billing could serve, in effect, as an interim substitute for implementing case-mix refinements. We believe that payment adjustments relating to case-mix would best be accomplished directly through refinements in the case-mix classification system. Further, we note that the Congress has already provided an interim adjustment until the refinements can be implemented, in the form of the temporary rate increases for certain specified RUG–III groups [enacted by section 101(a) of the BBRA, as amended by section 314 of the BIPA].

J. Application of the SNF PPS to SNF Services Furnished by Swing-Bed Hospitals

In the July 31, 2001 final rule (66 FR 39562), we announced the conversion of swing-bed hospitals to the SNF PPS, effective with the start of the provider's first cost reporting period beginning on or after July 1, 2002. We selected this date consistent with the statutory provision to integrate swing-bed hospitals into the SNF PPS by the end of the SNF transition period, that is, June 30, 2002.

As of July 31, 2003, the SNF PPS covers all swing-bed rural hospitals (as noted previously in section I.D of this final rule, section 203 of the BIPA exempted critical access hospital (CAH) swing-beds from the SNF PPS). Therefore, all rates and wage indices outlined in earlier sections of this final rule for SNF PPS also apply to all swing-bed hospitals. A complete discussion of assessment schedules, the MDS and the transmission software, Raven-SB for Swing Beds, can be found in the July 31, 2001 final rule (66 FR 39562). The latest changes in the MDS for swing-bed hospitals are listed on our SNF PPS Web site, *http://www.cms.hhs.gov/providers/snfpps/snfpps_mds.asp*.

K. Distinct Part Definition

In the May 16, 2003 proposed rule (68 FR 26777), we noted that while some SNFs function as separate, independent entities, we have recognized since the inception of the Medicare program that it is also possible for a SNF to operate as a component, or ''distinct part'' of a larger organization. However, there was no precise definition of a ''distinct part.'' In this final rule, we are clarifying the definition of a distinct part, by adopting a set of criteria that provides more precise guidance to providers and State licensure and certification agencies. This guidance will assist providers in understanding the criteria that govern the financial and organizational structure of these entities to facilitate the Medicare and Medicaid approval process.

Further, we proposed adopting certain additional criteria that would apply specifically to what we define in the rule as a composite distinct part SNF and/or NF. Under these criteria, a composite distinct part would be treated as a single distinct part of the institution of which it is a distinct part, and, as such, would operate under a single provider agreement with a single provider number. Further, to ensure quality of care and quality of life for all residents, we proposed that the composite distinct part would be required to meet all of the participation requirements set forth in subpart B of part 483 independently in each location. We also proposed amending § 483.10 and § 483.12 to afford certain protections and rights to residents located in a composite distinct part SNF and/or NF.

Comment: A commenter believed that the new criteria for distinct part certification were intended to determine if a facility was provider-based and a distinct part of a larger facility. Several other commenters believe that if a SNF meets the requirements of § 413.65 (provider-based), it is automatically considered a distinct part of the hospital to which it claims to be based.

Response: The distinct part certification requirements set forth in § 483.5 are separate and apart from the requirements to be considered ''provider based'' as set forth in § 413.65. Indeed, SNFs are no longer required to request or be approved for provider-based status and are not subject to the provider-based regulations in § 413.65. Moreover, simply meeting the provider-based requirements, which, as we have previously stated do not apply to SNFs, does not translate to automatically meeting the distinct part requirements. Accordingly, we will evaluate each request for approval of a distinct part SNF or NF against the criteria outlined in § 483.5.

Comment: Several facilities have questioned whether the receipt of a higher rate of Medicaid reimbursement is a justifiable reason for us to determine that a particular nursing facility is a part of a distinct part composite.

Response: We do not consider it an efficient use of public monies to approve a composite distinct part or, for that matter, a distinct part for the sole purpose of enhancing its Medicaid payment.

Comment: Several commenters recommend that we eliminate the condition that beds cannot be scattered throughout the facility.

Response: The Committee Report that accompanied the original Medicare legislation (Sen. Fin. Comm. Rep. No. 404, 89th Congress, 1st Session 31–32 (1965)) stated that a posthospital extended care facility could be an institution such as a skilled nursing home or a distinct part of an institution, such as a ward or wing of a hospital or a section of a facility another part of which might serve as an old age home. The regulations at 42 CFR 440.155 describe a distinct part as ''* * * an identifiable unit such as an entire ward or contiguous ward, a wing, floor or building.'' Thus, we believe that there is no legal basis for permitting the scattering of beneficiaries throughout the institution's physical plant. Also, the scattering of beneficiaries throughout the physical plant would make the survey and certification of SNFs and NFs a much more burdensome and complicated process. Finally, it would mean that we would be applying our rules to residents or beds *per se* rather than to providers. We apply our requirements to facilities, not beds or residents. Thus, the institution must clearly designate the area that is the proposed distinct part SNF and/or NF.

Comment: Several commenters suggested that we allow facilities to designate the number of beds to be approved and to identify those beds anywhere within the facility for cost accounting or survey purposes. The commenters add that in the approval process of a SNF distinct part, the facility would demonstrate to us the cost accounting methodology for a Medicare distinct part. Regulations for cost accounting for a Medicaid distinct part would be at the discretion of the State. The commenters indicate that, during the onsite survey, the facility would disclose the beds/rooms that the facility has designated as comprising the SNF or NF distinct part.

Response: We agree that an institution or institutional complex should be allowed to identify the number of beds to be approved in accordance with our policy. We also agree that an institution or institutional complex be allowed to identify the building(s) or identify parts of building(s) (that is wings, wards, or floors) where the distinct part is located as long as the location comports with the distinct part rules. However, for both cost accounting and survey and certification purposes, we must know in advance of the initial or recertification surveys, the number of beds in the distinct part and the location of the distinct part with respect to the entire complex. This assures that the surveying entity, either the State survey agency or our regional office, can allocate adequate resources to conduct the survey and then proceed directly to the distinct part to begin the survey. It also provides for adequate cost information from the provider's records to support payments made for services furnished to beneficiaries. If there are changes in the number of distinct part beds and/or their location in an approved distinct part facility, we must approve those changes in accordance with established policy.

Comment: One commenter states that we are forcing nursing homes to transfer residents to different rooms based on the certification of beds.

Response: We disagree with the commenter. It is the nursing home, not the Medicare or Medicaid program, that decides in which room an individual will be placed. As noted previously, facilities are certified, not beds. An individual, in selecting a nursing home for Medicare or Medicaid purposes, may choose any facility he/she likes provided the selected facility chooses to accept him or her. If a nursing home wants to place a person anywhere in the home, the facility could choose to have the entire nursing home participate in both Medicare and Medicaid.

Comment: Several commenters expressed concern with the ''close proximity'' requirements set forth in the definition of a distinct part relating to location. Another commenter even recommended that the definition of a distinct part exclude reference to location. Instead, the commenter suggested that the definition be revised to include being adjacent to, on the same campus of, or on multiple campuses of an institution that meets all the criteria of ownership and management control mentioned in § 483.5(b)(2). Yet another commenter believes that the requirements for location required that the distinct part be located strictly in the main building and not be allowed to exist at another location that is part of the institution's campus.

Response: In the definition of a distinct part set forth in the proposed rule of May 16, 2003 (68 FR 26758), we stated that an SNF or NF distinct part may be comprised of one or more buildings or designated parts of buildings (that is, wings, wards, or floors) that are—

• In the same physical area immediately adjacent to the institution's main buildings;

• Other areas and structures that are not strictly contiguous to the main buildings but are located within close proximity of the main buildings; and

• Any other areas that we determine on an individual basis, to be part of the institution's campus.

While we understand the concerns expressed by these commenters, we are retaining the language in the proposed rule regarding location and close proximity to afford flexibility in our determinations. It is our view that, in order to meet the requirements for supervision and control, and to function as an integral and subordinate part of the institution, with significant common resource usage of buildings, equipment, personnel and services, a distinct part would need to be located in close proximity to the institution of which it is a part. However, to clarify and address some of the commenters' concerns, we are revising § 483.5(b)(1) by clarifying that a distinct part SNF or NF is ''physically distinguishable from the larger institution'' rather than ''a physically identifiable component.'' As for concerns with respect to locations outside the institution's main building, we believe the definition provides flexibility to recognize distinct part SNFs or NFs that are not co-located at the institution's main building and, in conformity with the regulations as finalized, will continue to do so by making such determinations on an individual basis.

Comment: A commenter suggested that, instead of creating the term ''composite distinct part,'' we broaden the definition of distinct part, thus negating the necessity to make composite distinct part a separate term.

Response: Although we certainly want to keep our definitions of terms as simple and as realistic as possible, we are retaining our definition of a composite distinct part because the term best describes the situations we have encountered that were not previously addressed in regulations.

Comment: Several commenters recommended that existing SNFs and NFs that are a physically identifiable component of an institution be grandfathered as appropriate as a distinct part of that institution without having to submit a written request to us. Another commenter encouraged us to provide a transition period before implementation of the distinct part definition and composite distinct part definition to allow providers time to come into compliance with the accompanying requirements.

Response: We do not agree that existing distinct part SNFs and NFs should be grandfathered. All proposed and existing distinct parts must submit a written request to us as set forth at § 483.5(b)(2)(vi). At a minimum, an SNF and/or NF must demonstrate in writing how it meets the definition of a distinct part or composite distinct part. This definition has been discussed in detail in both the proposed rule and in this final rule, and provides extensive guidance to providers on compliance with these requirements.

The effective date of this final rule is October 1, 2003. However, in response to these comments, we will disseminate administrative guidance to implement the regulation with minimal burden to providers and States, in accordance with the requirement at § 483.5(b)(2)(vi).

Comment: A commenter suggested that we allow the approval to be a distinct part to be made on a retroactive basis.

Response: We disagree. The purpose of this regulation is to codify existing criteria for approval of distinct parts. For most facilities, the impact of this regulation will be that the criteria are easier to understand and can be more readily used by facility staff to monitor continued compliance. For those entities requesting initial Medicare and/or Medicaid approval, there is no reason that the SNF or NF could not be in compliance with the criteria at the time approval is requested. Indeed, we are requiring that a request for a distinct part be part of the Medicare and/or Medicaid approval process. The same is true in situations where there is a change of ownership or a change in bed size of an existing facility. When a provider is contemplating a change of ownership, the provider must notify us in advance; thus, we are requiring that a request for distinct part approval be included as part of its notification to us. In those instances where an existing SNF or NF requests a change in bed size, that request must be filed 45 days in advance of the change as stated in established policy; therefore, we are requiring that the request for distinct part approval be included in the request for a change in bed size.

Comment: There were a number of comments regarding specific administrative procedures, such as those relating to the process for requesting a distinct part approval and the appeal of a denial of a request.

Response: We believe that the detailed distinct part criteria set forth in the regulations, as discussed further in the proposed rule and in this final rule, already provide extensive guidance to providers on compliance with these requirements. However, as we noted in the July 31, 2000 final rule (65 FR 46791), and again in the July 31, 2001 final rule (66 FR 39588), specific operational instructions are beyond the scope of the SNF PPS final rule, and are addressed instead through program issuances.

Comment: A commenter had several questions regarding the term ''composite distinct part.'' The commenter asked whether an institution may operate two or more physically separate locations all of which would qualify as SNFs, and whether we will treat them as if they are a single SNF. On the other hand, if an institution operates a SNF at two locations, will only one location qualify as a SNF and the other will qualify as a NF? The commenter also asked whether all of the various locations comprise a single composite distinct part or whether each location itself qualifies as a composite distinct part.

Response: By definition, a composite distinct part is a combination of two or more physically separate locations where SNF and/or NF services are provided, all of which operate under a single Medicare or Medicaid provider agreement, constituting a single distinct part SNF and/or a single distinct part NF.

Comment: A commenter requested that we further explain the administrative implications relating to a composite distinct part SNF or NF. The commenter specifically asked for guidance with respect to the filing of the Medicare cost report, the selection of a cost reporting period, the issuance of a provider number, the selection of a fiscal intermediary, and any additional administrative requirements.

Response: As we have stated above, a composite distinct part is in fact a combination of two or more physically separated locations where SNF and/or NF services are provided, all of which operate under a single Medicare or Medicaid provider agreement, constituting a single distinct part SNF and/or a single distinct part NF. Therefore, a composite distinct part SNF must file a single Medicare cost report, use the same cost reporting period selected by the institution of which it is a distinct part, use a single provider number and the same fiscal intermediary as that selected by the institution of which it is a distinct part. The composite distinct part is subject to the change in bed size policies that we establish for all SNFs and NFs.

Comment: Several commenters were unclear as to the reason why we were creating the term ''composite distinct part.''

Response: As we stated in the proposed rule of May 16, 2003 (68 FR 26758), the growing frequency of hospital mergers (in which each of the merging hospitals brings its own distinct part SNF and/or NF into the merger) has created situations where the newly merged hospital entity includes multiple physical plants in which SNF and/or NF services are provided in different physical locations: that is, the creation of a composite distinct part SNF and/or NF. Moreover, that hospital might additionally purchase a freestanding SNF and/or NF for use in placing those of its inpatients who are ready for hospital discharge. Existing guidance on what constitutes a distinct part does not address these types of situations. Thus, we have established these criteria in an effort to reduce uncertainty and to allow providers to make informed decisions. This rule also establishes protections for beneficiaries who reside in composite distinct parts.

Comment: A commenter questioned if States would be required to apply the same definition in determining distinct part approval for purposes of State licensing and Medicaid reimbursement laws.

Response: The criteria and definitions set forth in this rule apply to SNFs and NFs that are approved to participate in either the Medicare program or the State Medicaid program (or both). As such, for participation in the Medicare and/or Medicaid programs, the criteria in this rule must be met.

Comment: A commenter stated that we should consider CMS staff time that will be required to approve mergers.

Response: Providers who are participating in the Medicare and/or Medicaid program are required to notify us of any proposed change of ownership before the effective date of the transaction, since these transactions directly affect the provider agreement. Reviewing these transactions is a function that our Regional Offices are currently performing and will not require additional CMS staff time.

In the proposed § 483.5(c)(2)(iii), we inadvertently used the term ''hospitals'' rather than ''institutions'' in our discussion of changes of ownership. We are revising § 483.5(c)(2)(iii) by replacing the word ''hospitals'' with ''institutions,'' since this provision is meant to apply more generally to institutions, which could include, but are not limited to, hospitals. We are also replacing the word ''merged'' with ''change of ownership'' throughout the regulations text since this provision more accurately applies in all cases where there is a change of ownership. For the same reason, we are deleting the examples referencing hospitals at § 483.5(b)(1).

Comment: A commenter stated that our policy of allowing only one distinct part SNF and/or one distinct part NF is problematic as it could jeopardize the funding for certain programs that are predicated on specific State program requirements.

Response: It has been our longstanding policy that an institution or institutional complex only be allowed to have one distinct part SNF and/or one distinct part NF. Moreover, our policy is based on sections 1819(a) and 1919(a) of the Act, which define a SNF and a NF, respectively, as ''an institution (or a distinct part of an institution). * * *'' It is our view that this reference to the singular, that is, ''a'' distinct part indicates that the Congress did not contemplate permitting the establishment of more than one distinct part SNF or NF in any given institution. This language is also reflected in the Committee Report accompanying the original Medicare legislation previously discussed in the May 16, 2003 proposed rule (68 R 26777).

Comment: Several commenters suggested the term ''distinct part'' be defined using language that had previously appeared in the State Operations Manual § 2110, ''The term 'distinct part' denotes that the unit is organized and operated to give a distinct type of care within a larger organization which otherwise renders other types or levels of care. * * *''

Response: We are not making the revision, as suggested by the commenters, because this would necessitate a change in the statute.

Comment: Two commenters expressed a concern that the restrictions on room changes made within the locations of the composite distinct part would affect the transfer of residents between levels of care (that is, skilled nursing facility services are provided in one location of the composite distinct part and nursing facility services are provided in another location of the composite distinct part.)

Response: We do not consider the resident protections in newly added § 483.12(a)(8) that apply to room changes to have any impact on residents transferring between different levels of care within a composite distinct part. There is a distinction between room changes and transfers. Room changes occur within the same certified facility, such as within a composite distinct part. Section 483.12(a)(1) defines transfers and discharges as, ''* * * movement of a resident to a bed outside of the certified facility whether that bed is in the same physical plant or not. Transfer and discharge does not refer to the movement of a resident within the same certified facility.''

Comment: The commenter urged us to implement the definitions for distinct parts and composite distinct parts in a manner that neither adds administrative burden on SNFs or NFs, nor adversely affects their quality of care or financial status. The commenter stated further that State Medicaid programs and other payers should not be required to use the new definitions, and that the creation of the definitions should not hamper their ability to use the previous definitions.

Response: It is not our intent in defining the terms distinct part and composite distinct part to add to a SNF's or NF's administrative burdens or to adversely affect the quality of care provided to the residents, or to affect the SNF's or NF's financial status. We believe that our definitions of these terms should be clearly stated in regulations in order to reduce uncertainty and allow providers to make informed decisions and enhance the survey and certification process.

We do expect that the distinct part regulations be applied to SNFs participating in the Medicare program and NFs participating in the Medicaid program in exactly the same manner. As we have discussed previously, the statutory definitions of a SNF and a NF that appear in sections 1819(a) and 1919(a) of the Act, respectively, use identical language, ''an institution (or a distinct part of an institution)'' and thus are not intended to be treated differently. Moreover, § 440.155 and the Medicare guidelines concerning distinct parts have always correlated, and we believe that to allow different distinct part rules for the two programs would only create confusion and would not be consistent with the intent of the Congress. We are also making editorial technical changes to § 440.40(a)(1)(ii)(A), § 483.5(b)(1), § 483.5(b)(2), § 483.5(c), and § 483.10(b)(12). These were made solely to clarify and make more understandable the regulations text.

L. Quality of Care Efforts Under the SNF PPS

In the supplemental proposed rule (68 FR 34772), we expressed our expectation that the majority of any additional payments that might result from the introduction of a forecast error adjustment (as discussed previously in section III.H.3 of this final rule) would be used for direct care services to nursing home residents and quality improvement activities and programs. We also solicited comments on how SNFs could account for these direct care funds, and on how we can further promote quality improvement efforts among SNFs.

Comment: A number of commenters pointed out that a primary objective of any prospective payment system is to allow providers the flexibility to manage their facilities effectively and to allocate their funding to best serve the needs of their patients. These commenters generally agreed that providers should use this flexibility to develop innovative programs to ensure high quality care, but generally did not support targeting funding to a specific service or rate component. Several commenters referenced several locally-developed programs focusing on quality improvement and customer satisfaction as examples of provider initiatives in a PPS environment. On the other hand, a few commenters took a more positive view of targeted payment rates, and recommended that we consider recent State initiatives that incorporate quality incentives or establish mandatory SNF staffing ratios.

Response: In considering the adoption of a market basket forecast error adjustment, we carefully evaluated industry comments for the implications of targeting this additional funding to quality improvements. While generally positive about the need to maintain and enhance direct care services, many commenters strongly urged us to maintain the integrity of the PPS as the best means of achieving improved patient care. These commenters maintained that the most effective way to manage operations and improve quality is to allow managers the flexibility they need to address the needs of their patients quickly. They expressed concern that earmarking funds for a specific care component (such as nurse staffing or pharmaceuticals) would restrict rather than enhance this flexibility, and could result in a negative, rather than a positive impact on patient care. While we strongly support the development of quality incentives within the structure of our payment systems, we agree that any such initiatives will need to be carefully designed and tested to ensure an appropriate and beneficial effect on direct care and patient outcomes.

A few commenters recommended that we establish specific quality and/or staffing standards. Although we do have research data that links staffing levels and patient outcomes, these research projects have not provided us with the specific analyses (including the trade off between cost and quality) that we would need to establish either minimum or recommended staffing levels, or to adjust those staffing levels for specific acuity or functional limitation populations. Therefore, it became apparent that we do not currently have a clear way to target payments to quality improvements in a uniform manner that will benefit the Medicare program in general. However, we want to reiterate our expectation that this additional funding be used to improve direct care. We strongly encourage providers to continue their efforts to develop and expand programs such as the grass roots initiatives discussed later in this preamble that promote high quality care.

We are also continuing to explore a variety of quality initiatives, including the relationship between staffing and quality outcomes. We have recently awarded a contract to generate an informed set of CMS options for establishing a system of public reporting of nursing home staffing information. The report will detail a set of options for us to consider with respect to which data elements to collect, and how those data elements can best be transmitted, audited, and displayed on our Web site along with other consumer information. The data obtained with this contract will be used in continuing analysis of staffing levels and resident outcomes. We are also in the process of awarding another contract that will expand on the current nurse staffing study. This contract will examine staffing in general in an attempt to develop a quality measure(s) for reporting as part of the Nursing Home Quality Initiative (NHQI) effort.

Finally, the Department has recently completed, under contract, a study of State-initiated nursing home quality programs and will soon be completing another contracted study on State-initiated nursing home nurse staffing ratios. We plan to further investigate various State initiatives designed to integrate quality incentives into their payment systems. For example, some States already tie direct care reimbursement to actual direct care staffing expenditures. In addition, other States are looking at a variety of best practice standards that could be monitored and recognized through incentive payments. We plan to incorporate any promising State initiatives into our ongoing research efforts, which could serve as the basis for future recommendations.

Comment: Several commenters pointed out that the national nursing facility trade associations and their State affiliates are already strongly committed to enhancing quality, and described a number of grass roots initiatives, including State-wide customer service and public reporting programs, State-association-run quality monitoring and early warning systems, and a variety of programs to train staff, provide career ladders, and increase retention. These commenters pointed out that the national nursing facility trade associations have strongly supported the development of our quality measures, and are working in partnership with us on a number of other quality initiatives. Other commenters cited industry interest in and support for a number of initiatives, including the Eden Alternative, Wellspring, and the Pioneer Network, which have demonstrated the ability to attract and retain high quality staff.

Response: We have focused significant resources in the past two years on improving the quality of health care provided by Medicare providers. Our efforts with respect to nursing home quality have been particularly intensive. We recognize that several national organizations and their members have worked with us on several quality initiatives, including the Nursing Home Quality Initiative (NHQI). The NHQI is a four-prong effort that consists of—

- Regulation and enforcement efforts conducted by State survey agencies and by us;
- Improved consumer information on the quality of care in nursing homes;
- Continual, community-based quality improvement programs designed to help nursing homes improve their quality of care; and
- Collaboration and partnership to utilize available knowledge and resources effectively.

We are pleased that several commenters shared their efforts to have a positive impact on beneficiaries' outcomes. A variety of programs have been designed on the State or organization level to improve staff knowledge and expertise by providing unique training and educational opportunities. In addition, many providers are participating in several new and innovative programs that explore different ways to better serve patients. For example, the Pioneer Network, Eden Alternative, and Wellspring programs are designed to impart a culture change that positively influences the aging population. Providers involved in these three programs report improvements in staff retention, staff morale, and resident outcomes, including decreased pharmaceutical utilization and improved mobility. These improvements have also been associated with more positive patient outcomes, as evidenced by the results of State surveys.

We encourage the national associations and their affiliates to communicate information on these innovative programs to their entire membership, and to encourage expansion of these innovative programs across the country. We also encourage the development of partnerships among nursing homes, CMS, the State agencies, Quality Improvement Organizations (QIOs), consumers, and other stakeholders in developing and promoting programs designed to maintain and enhance high quality care. We also encourage the national organizations to continue to share information on potential quality initiatives with and between their State affiliates and providers. Finally, we encourage these stakeholders to work with us to design Federal demonstration projects to examine more fully a variety of quality models, including the development of payment systems with integrated quality incentives.

IV. Provisions of the Final Rule

The provisions of this final rule are as follows:

- We are revising § 411.15(p)(2)(xii) to incorporate additional chemotherapy service exclusions from SNF consolidated billing, as well as a conforming revision in the regulations at § 489.20(s)(12).
- We are revising § 413.337(d) by adding a new paragraph (2), which establishes an adjustment to the annual increase in the SNF market basket index amount to account for forecast error.
- We are revising § 483.5 to include specific definitions of the terms ''distinct part'' and ''composite distinct part.'' We are also making conforming changes in subpart B of part 483 of the regulations, as well as in parts 413 and 440.

In addition, we are making the following technical corrections in the regulations text, as discussed in the proposed rule:

- We are revising a cross-reference that appears in § 409.20(c) of the regulations. Section 409.20 provides a general introduction to the subsequent sections (§ 409.21 through § 409.36) that set forth the specific requirements pertaining to the SNF benefit. However, in referring to the sections that follow, the cross-reference in § 409.20(c) concerning terminology inadvertently omits a reference to § 409.21, and we are now correcting that omission by revising the cross-reference to read ''§ 409.21 through § 409.36''.
- We are correcting the spelling of the word ''describe'' as it appears in the second sentence of the regulations text at § 483.20(k)(1).

Also, as discussed in the supplemental proposed rule, we are correcting the spelling of the word ''standardized'' in the second sentence of § 413.345 of the regulations. Further, we are taking this opportunity to make the following additional technical corrections:

- We are restoring a portion of the regulations text that was inadvertently deleted from § 488.438(d), dealing with civil money penalties. As originally published in the **Federal Register** on November 10, 1994 (59 FR 56248), paragraph (d) of § 88.438 contained three numbered paragraphs. However, when this section of the regulations was republished on March 18, 1999 (64 FR 13361), paragraph (3) was inadvertently omitted. Accordingly, we are now restoring this portion of the regulations text, which reads as follows: ''(3) Repeated deficiencies are deficiencies in the same regulatory grouping of requirements found at the last survey, subsequently corrected, and found again at the next survey.''
- In paragraph (d) of § 489.22, which deals with prepayment requirements in providers, we are correcting the phrase ''covered impatient services'' to read ''covered inpatient services''.

V. Waiver of Proposed Rulemaking

We ordinarily publish a notice of proposed rulemaking in the **Federal Register** to provide a period for public comment before the provisions of the technical corrections included in this final rule take effect. We can waive this procedure, however, if we find good cause that a notice and comment procedure is impracticable, unnecessary, or contrary to the public interest and incorporate a statement of the finding and its reasons in the notice issued.

We find it unnecessary to undertake notice and comment rulemaking as to these technical changes as they merely provide technical corrections to the regulations and do not make any substantive changes to the regulations. Therefore, for good cause, we waive notice and comment procedures.

VI. Collection of Information Requirements

This document does not impose information collection and recordkeeping requirements. Consequently, it need not be reviewed by the Office of Management and Budget under the authority of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 *et seq.*).

VII. Regulatory Impact Analysis

A. Overall Impact

We have examined the impacts of this final rule as required by Executive Order 12866 (September 1993, Regulatory Planning and Review), the Regulatory Flexibility Act (RFA) (September 16, 1980, Pub. L. 96–354), section 1102(b) of the Social Security Act (the Act), the Unfunded Mandates Reform Act of 1995 (UMRA), (Pub. L. 104–4), and Executive Order 13132.

Executive Order 12866 (as amended by Executive Order 13258, which merely assigns responsibility of duties) directs agencies to assess all costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). A regulatory impact analysis (RIA) must be prepared for major rules with economically significant effects ($100 million or more in any 1 year). This final rule is a major rule, as defined in Title 5, United States Code, section 804(2), because we estimate the impact of the standard update will increase payments to SNFs by approximately $400 million. In addition, we have adjusted the FY 2004 rates to reflect the 3.26 percent cumulative forecast error since the start of the SNF PPS on July 1, 1998. This adjustment increases payments to SNFs by an additional $450 million, for an aggregate increase in payments of $850 million.

The update set forth in this final rule applies to payments in FY 2004. Accordingly, the analysis that follows describes the impact of this one fiscal year only. In accordance with the requirements of the Act, we will publish a notice for each subsequent fiscal year that will provide for an update to the payment rates and that will include an associated impact analysis.

The RFA requires agencies to analyze options for regulatory relief of small businesses. For purposes of the RFA, small entities include small businesses, nonprofit organizations, and government agencies. Most SNFs and most other providers and suppliers are small entities, either by their nonprofit status or by having revenues of $11.5 million or less in any 1 year. For purposes of the RFA, approximately 53 percent of SNFs are considered small businesses according to the Small Business Administration's latest size standards with total revenues of $11.5 million or less in any 1 year (for further information, see 65 FR 69432, November 17, 2000). Individuals and

States are not included in the definition of a small entity.

This final rule updates the SNF PPS rates published in the July 31, 2002 update notice (67 FR 49798), thereby increasing aggregate payments by an estimated $850 million. As indicated in Table 11, the effect on facilities will be an aggregate positive impact of 6.4 percent. We note that some individual providers may experience larger increases in payments than others due to the distributional impact of the FY 2004 wage indices and the degree of Medicare utilization. While this final rule is a major rule, its overall impact is extremely small; that is, less than 3 percent of total SNF revenues from all payor sources. Since the overall impact is positive on the industry as a whole, and on small entities specifically, it is not necessary to consider regulatory alternatives.

In addition, section 1102(b) of the Act requires us to prepare a regulatory impact analysis if a rule may have a significant impact on the operations of a substantial number of small rural hospitals. For a final rule, this analysis must conform to the provisions of section 604 of the RFA. For purposes of section 1102(b) of the Act, we define a small rural hospital as a hospital that is located outside of a Metropolitan Statistical Area and has fewer than 100 beds. Because the payment rates set forth in this final rule also affect rural hospital swing-bed services, we believe that this final rule will have a positive fiscal impact on small rural hospitals. However, because this incremental increase in payments for Medicare swing-bed services is relatively minor in comparison to overall rural hospital revenues, this final rule will not have a significant impact on the overall operations of these small rural hospitals.

Section 202 of the Unfunded Mandates Reform Act of 1995 also requires that agencies assess anticipated costs and benefits before issuing any rule that may result in an expenditure in any 1 year by State, local, or tribal governments, in the aggregate, or by the private sector, of $110 million or more. This final rule will increase payments to SNFs by over 6 percent, but will have no other substantial effect on State, local, or tribal governments. Again, we believe that the aggregate impact of this major rule is positive, and does not meet the significance thresholds for determining added costs under the Unfunded Mandates Reform Act.

Executive Order 13132 establishes certain requirements that an agency must meet when it promulgates a proposed rule (and subsequent final rule) that imposes substantial direct requirement costs on State and local governments, preempts State law, or otherwise has Federalism implications. As stated above, this final rule will have no substantial effect on State and local governments.

The purpose of this final rule is not to initiate significant policy changes with regard to the SNF PPS; rather, it is to provide an update to the rates for FY 2004 and to address a number of policy issues related to the PPS. We believe that the revisions and clarifications mentioned elsewhere in this final rule (for example, with respect to determining distinct part status) will have, at most, only a negligible overall effect upon the regulatory impact estimate specified in the rule. As such, these revisions will not represent an additional burden to the industry.

B. Anticipated Effects

This final rule sets forth updates of the SNF PPS rates contained in the July 31, 2002 update (67 FR 49798). The impact analysis of this final rule represents the projected effects of the changes in the SNF PPS from FY 2003 to FY 2004. We estimate the effects by estimating payments while holding all other payment variables constant. We use the best data available, but we do not attempt to predict behavioral responses to these changes, and we do not make adjustments for future changes in such variables as days or case-mix.

This analysis incorporates the latest estimates of growth in service use and payments under the Medicare SNF benefit, based on the latest available Medicare claims from 2001. We note that certain events may combine to limit the scope or accuracy of our impact analysis, because such an analysis is future-oriented and, thus, very susceptible to forecasting errors due to other changes in the forecasted impact time period. Some examples of such possible events are newly-legislated general Medicare program funding changes by the Congress, or changes specifically related to SNFs. In addition, changes to the Medicare program may continue to be made as a result of the BBA, the BBRA, the BIPA, or new statutory provisions. Although these changes may not be specific to the SNF PPS, the nature of the Medicare program is such that the changes may interact, and the complexity of the interaction of these changes could make it difficult to predict accurately the full scope of the impact upon SNFs.

In accordance with section 1888(e)(4)(E) of the Act, the payment rates for FY 2004 are updated by a factor equal to the market basket index percentage increase to determine the payment rates for FY 2004. We note that in accordance with section 101(a) of the BBRA and section 314 of the BIPA, the existing, temporary increase in the per diem adjusted payment rates of 20 percent for certain specified RUGs (and 6.7 percent for certain others) remains in effect until the implementation of case-mix refinements. In updating the rates for FY 2004, we made a number of standard annual revisions and clarifications mentioned elsewhere in this notice (for example, the update to the wage and market basket indices used for adjusting the Federal rates). These revisions will increase payments to SNFs by approximately $400 million. In addition, we have adjusted the FY 2004 rates to reflect the 3.26 percent cumulative forecast error since the start of the SNF PPS on July 1, 1998. This adjustment increases payments to SNFs by an additional $450 million, for an aggregate increase in payments of $850 million.

The impacts are shown in Table 11. The breakdown of the various categories of data in the table follows.

The first column shows the breakdown of all SNFs by urban or rural status, hospital-based or freestanding status, and census region.

The first row of figures in the first column describes the estimated effects of the various changes on all facilities. The next six rows show the effects on facilities split by hospital-based, freestanding, urban, and rural categories. The next twenty rows show the effects on urban versus rural status by census region. The final four rows show the effects on facilities by ownership type.

The second column in the table shows the number of facilities in the impact database.

The third column of the table shows the effect of the annual update to the wage index. The total impact of this change is zero percent; however, there are distributional effects of the change.

The fourth column of the table shows the effect of all of the changes on the FY 2003 payments. The market basket increase of 3.0 percentage points is constant for all providers and, though not shown individually, is included in the total column. Similarly, the 3.26 percent forecast error adjustment is included in the fourth column and is constant for all providers. It is projected that aggregate payments will increase by 6.4 percent in total, assuming facilities do not change their care delivery and billing practices in response.

As can be seen from this table, the combined effects of all of the changes vary by specific types of providers and by location.

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Table 11

Projected Impact of FY 2004 Update to the SNF PPS

	Number of facilities	Wage Index Change	Total FY 2004 change
Total	13,944	0.0%	6.4%
Urban	9,485	-0.1%	6.3%
Rural	4,459	0.5%	6.9%
Hospital based urban	1,049	-0.1%	6.3%
Freestanding urban	7,885	-0.1%	6.3%
Hospital based rural	660	0.5%	6.9%
Freestanding rural	3,500	0.5%	6.9%
Urban by region			
New England	911	0.1%	6.5%
Middle Atlantic	1,469	-0.7%	5.6%
South Atlantic	1,522	0.2%	6.6%
East North Central	1,823	-0.5%	5.8%
East South Central	410	0.4%	6.8%
West North Central	662	0.4%	6.8%
West South Central	847	0.2%	6.6%
Mountain	413	0.8%	7.2%
Pacific	1,422	0.1%	6.5%
Rural by region			
New England	129	-0.2%	6.1%
Middle Atlantic	238	-0.4%	5.9%
South Atlantic	627	0.3%	6.7%
East North Central	845	0.9%	7.3%
East South Central	479	-0.2%	6.1%
West North Central	1,045	1.7%	8.2%
West South Central	605	-0.1%	6.3%
Mountain	303	1.3%	7.7%
Pacific	188	0.4%	6.8%
Ownership			
Government	701	0.0%	6.4%
Proprietary	8,839	0.0%	6.4%
Voluntary	3,514	-0.1%	6.3%

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C. Alternatives Considered

Section 1888(e) of the Act establishes the SNF PPS for the payment of Medicare SNF services for cost reporting periods beginning on or after July 1, 1998. This section of the statute prescribes a detailed formula for calculating payment rates under the SNF PPS, and does not provide for the use of any alternative methodology. It specifies that the base year cost data to be used for computing the RUG-III payment rates must be from FY 1995 (October 1, 1994, through September 30, 1995.) In accordance with the statute, we also incorporated a number of elements into the SNF PPS, such as case-mix classification methodology, the MDS assessment schedule, a market basket index, a wage index, and the urban and rural distinction used in the development or adjustment of the Federal rates. Further, section 1888(e)(4)(H) of the Act specifically requires us to publish the payment rates for each new fiscal year in the **Federal Register**, and to do so before the August 1 that precedes the start of the new fiscal year. Accordingly, we are not pursuing alternatives.

D. Conclusion

For the reasons set forth in the preceding discussion, we are not preparing analyses for either the RFA or section 1102(b) of the Act because we have determined that this final rule will not have a significant economic impact on a substantial number of small entities or a significant impact on the operations of a substantial number of small rural hospitals.

Finally, in accordance with the provisions of Executive Order 12866, this regulation was reviewed by the Office of Management and Budget.

List of Subjects

42 CFR Part 409

Health facilities, Medicare.

42 CFR Part 411

Kidney diseases, Medicare, Reporting and recordkeeping requirements.

42 CFR Part 413

Health facilities, Kidney diseases, Medicare, Reporting and recordkeeping requirements.

42 CFR Part 440

Grants programs—health, Medicaid.

42 CFR Part 483

Grants programs-health, Health facilities, Health professions, Health records, Medicaid, Medicare, Nursing homes, Nutrition, Reporting and recordkeeping requirements, Safety.

42 CFR Part 488

Health facilities, Medicare, Reporting and recordkeeping requirements.

42 CFR Part 489

Health facilities, Medicare, Reporting and recordkeeping requirements.

■ For the reasons set forth in the preamble, the Centers for Medicare & Medicaid Services amends 42 CFR chapter IV as follows:

PART 409—HOSPITAL INSURANCE BENEFITS

■ 1. The authority citation for part 409 continues to read as follows:

Authority: Secs. 1102 and 1871 of the Social Security Act (42 U.S.C. 1302 and 1395hh).

Subpart C—Posthospital SNF Care

■ 2. In § 409.20, the introductory text to paragraph (c) is revised to read as follows:

§ 409.20 Coverage of services.

* * * * *

(c) *Services not generally provided by (or under arrangements made by) SNFs.* In § 409.21 through § 409.36—

* * * * *

PART 411—EXCLUSIONS FROM MEDICARE AND LIMITATIONS ON MEDICARE PAYMENT

■ 1. The authority citation for part 411 continues to read as follows:

Authority: Secs. 1102 and 1871 of the Social Security Act (42 U.S.C. 1302 and 1395hh).

Subpart A—General Exclusions and Exclusion of Particular Services

■ 2. Section 411.15 is amended by:

■ A. Republishing the introductory text to the section and the paragraph (p)(2) introductory text.

■ B. Revising paragraph (p)(2)(xii).

§ 411.15 Particular services excluded from coverage.

The following services are excluded from coverage.

* * * * *

(p) *Services furnished to SNF residents.* * * *

(2) *Exceptions.* The following services are not excluded from coverage, provided that the claim for payment includes the SNF's Medicare provider number in accordance with § 424.32(a)(5) of this chapter:

* * * * *

(xii) Those chemotherapy items identified, as of July 1, 1999, by HCPCS codes J9000–J9020; J9040–J9151; J9170–J9185; J9200–J9201; J9206–J9208; J9211; J9230–J9245; and J9265–J9600; and, as of January 1, 2004, by HCPCS codes A9522 and A9523.

* * * * *

PART 413—PRINCIPLES OF REASONABLE COST REIMBURSEMENT; PAYMENT FOR END-STAGE RENAL DISEASE SERVICES; PROSPECTIVELY DETERMINED PAYMENT RATES FOR SKILLED NURSING FACILITIES

■ 1. The authority citation for part 413 continues to read as follows:

Authority: Secs. 1102, 1812(d), 1814(b), 1815, 1833(a), (i) and (n), 1861(v), 1871, 1881, 1883, and 1886 of the Social Security Act (42 U.S.C. 1302, 1395d(d), 1395f(b), 1395g, 1395l(a), (i), and (n), 1395x(v), 1395hh, 1395rr, 1395tt, and 1395ww).

Subpart E—Payments to Providers

■ 2. In § 413.65, paragraph (a)(1)(ii)(D) is revised to read as follows:

§ 413.65 Requirements for a determination that a facility or an organization has provider-based status.

(a) *Scope and definitions.* (1) *Scope.* * * *

(ii) * * *

(D) Skilled nursing facilities (SNFs) (determinations for SNFs are made in accordance with the criteria set forth in § 483.5 of this chapter).

* * * * *

Subpart J—Prospective Payment for Skilled Nursing Facilities

■ 3. In § 413.337, paragraph (d)(2) is revised to read as follows:

§ 413.337 Methodology for calculating the prospective payment rates.

* * * * *

(d) *Annual updates of Federal unadjusted payment rates.*

(2) For subsequent fiscal years, the unadjusted Federal rate is equal to the rate for the previous fiscal year increased by the applicable SNF market basket index amount. Beginning with fiscal year 2004, an adjustment to the annual update of the previous fiscal year's rate will be computed to account for forecast error. The initial adjustment (in fiscal year 2004) to the update of the previous fiscal year's rate will take into account the cumulative forecast error between fiscal years 2000 and 2002. Subsequent adjustments in succeeding fiscal years will take into account the forecast error from the most recently available fiscal year for which there is final data.

* * * * *

§ 413.345 [Amended]

4. In the second sentence of § 413.345, the word ''tandardized'' is removed and the word ''standardized'' is added in its place.

PART 440—SERVICES: GENERAL PROVISIONS

■ 1. The authority citation for part 440 continues to read as follows:

Authority: Sec. 1102 of the Social Security Act (42 U.S.C. 1302).

Subpart A—Definitions

■ 2. In § 440.40, paragraph (a)(1)(ii)(A) is revised to read as follows:

§ 440.40 Nursing facility services for individuals age 21 or older (other than services in an institution for mental disease), EPSDT, and family planning services and supplies.

(a) * * *

(1) * * *

(ii) * * *

(A) A facility or distinct part (as defined in § 483.5(b) of this chapter) that meets the requirements for participation under subpart B of part 483 of this chapter, as evidenced by a valid agreement between the Medicaid agency and the facility for providing nursing facility services and making payments for services under the plan; or

* * * * *

■ 2a. In § 440.155, the introductory text to paragraph (c) is revised to read as follows:

§ 440.155 Nursing facility services, other than in institutions for mental diseases.

* * * * *

(c)''Nursing facility services'' may include services provided in a distinct part (as defined in § 483.5(b) of this chapter) of a facility other than a nursing facility if the distinct part (as defined in § 483.5(b) of this chapter)—

* * * * *

PART 483—REQUIREMENTS FOR STATES AND LONG TERM CARE FACILITIES

■ 1. The authority citation for part 483 continues to read as follows:

Authority: Secs. 1102 and 1871 of the Social Security Act (42 U.S.C. 1302 and 1395hh).

Subpart B—Requirements for Long Term Care Facilities

■ 2. Section 483.5 is revised to read as follows:

§ 483.5 Definitions.

(a) *Facility defined.* For purposes of this subpart, *facility* means a skilled nursing facility (SNF) that meets the requirements of sections 1819(a), (b), (c), and (d) of the Act, or a nursing facility (NF) that meets the requirements of sections 1919(a), (b), (c), and (d) of the Act. ''Facility'' may include a distinct part of an institution (as defined in paragraph (b) of this section and specified in § 440.40 and § 440.155 of this chapter), but does not include an institution for the mentally retarded or persons with related conditions described in § 440.150 of this chapter. For Medicare and Medicaid purposes (including eligibility, coverage, certification, and payment), the ''facility'' is always the entity that participates in the program, whether that entity is comprised of all of, or a distinct part of, a larger institution. For Medicare, an SNF (*see* section 1819(a)(1) of the Act), and for Medicaid, an NF (*see* section 1919(a)(1) of the Act) may not be an institution for mental diseases as defined in § 435.1009 of this chapter.

(b) *Distinct part*—(1) *Definition.* A distinct part SNF or NF is physically distinguishable from the larger institution or institutional complex that houses it, meets the requirements of this paragraph and of paragraph (b)(2) of this section, and meets the applicable statutory requirements for SNFs or NFs in sections 1819 or 1919 of the Act, respectively. A distinct part SNF or NF may be comprised of one or more buildings or designated parts of buildings (that is, wings, wards, or floors) that are: In the same physical area immediately adjacent to the institution's main buildings; other areas and structures that are not strictly contiguous to the main buildings but are located within close proximity of the main buildings; and any other areas that CMS determines on an individual basis, to be part of the institution's campus. A distinct part must include all of the beds within the designated area, and cannot consist of a random collection of individual rooms or beds that are scattered throughout the physical plant. The term ''distinct part'' also includes a composite distinct part that meets the additional requirements of paragraph (c) of this section.

(2) *Requirements.* In addition to meeting the participation requirements for long-term care facilities set forth elsewhere in this subpart, a distinct part SNF or NF must meet all of the following requirements:

(i) The SNF or NF must be operated under common ownership and control (that is, common governance) by the institution of which it is a distinct part, as evidenced by the following:

(A) The SNF or NF is wholly owned by the institution of which it is a distinct part.

(B) The SNF or NF is subject to the by-laws and operating decisions of a common governing body.

(C) The institution of which the SNF or NF is a distinct part has final responsibility for the distinct part's administrative decisions and personnel policies, and final approval for the distinct part's personnel actions.

(D) The SNF or NF functions as an integral and subordinate part of the institution of which it is a distinct part, with significant common resource usage of buildings, equipment, personnel, and services.

(ii) The administrator of the SNF or NF reports to and is directly accountable to the management of the institution of which the SNF or NF is a distinct part.

(iii) The SNF or NF must have a designated medical director who is responsible for implementing care policies and coordinating medical care, and who is directly accountable to the management of the institution of which it is a distinct part.

(iv) The SNF or NF is financially integrated with the institution of which it is a distinct part, as evidenced by the sharing of income and expenses with that institution, and the reporting of its costs on that institution's cost report.

(v) A single institution can have a maximum of only one distinct part SNF and one distinct part NF.

(vi) (A) An institution cannot designate a distinct part SNF or NF, but instead must submit a written request with documentation that demonstrates it meets the criteria set forth above to CMS to determine if it may be considered a distinct part.

(B) The effective date of approval of a distinct part is the date that CMS determines all requirements (including enrollment with the fiscal intermediary (FI)) are met for approval, and cannot be made retroactive.

(C) The institution must request approval from CMS for all proposed changes in the number of beds in the approved distinct part.

(c) *Composite distinct part*—(1) *Definition.* A composite distinct part is a distinct part consisting of two or more noncontiguous components that are not located within the same campus, as defined in § 413.65(a)(2) of this chapter.

(2) *Requirements.* In addition to meeting the requirements of paragraph (b) of this section, a composite distinct part must meet all of the following requirements:

(i) A SNF or NF that is a composite of more than one location will be treated as a single distinct part of the institution of which it is a distinct part. As such, the composite distinct part will have only one provider agreement and only one provider number.

(ii) If two or more institutions (each with a distinct part SNF or NF) undergo a change of ownership, CMS must approve the existing SNFs or NFs as meeting the requirements before they are considered a composite distinct part of a single institution. In making such a determination, CMS considers whether its approval or disapproval of a composite distinct part promotes the effective and efficient use of public monies without sacrificing the quality of care.

(iii) If there is a change of ownership of a composite distinct part SNF or NF, the assignment of the provider agreement to the new owner will apply to all of the approved locations that comprise the composite distinct part SNF or NF.

(iv) To ensure quality of care and quality of life for all residents, the various components of a composite distinct part must meet all of the requirements for participation independently in each location.

■ 3. In § 483.10, the following new paragraph (b)(12) is added to read as follows:

§ 483.10 Resident rights.

* * * * *

(b) * * *

(12) *Admission to a composite distinct part.* A facility that is a composite distinct part (as defined in § 483.5(c) of this subpart) must disclose in its admission agreement its physical configuration, including the various locations that comprise the composite distinct part, and must specify the policies that apply to room changes between its different locations under § 483.12(a)(8).

* * * * *

■ 4. In § 483.12, the following changes are made:

■ A. A new paragraph (a)(8) is added.

■ B. A new paragraph (b)(4) is added.

The additions read as follows:

§ 483.12 Admission, transfer, and discharge rights.

(a) * * *

(8) *Room changes in a composite distinct part.* Room changes in a facility that is a composite distinct part (as defined in § 483.5(c)) must be limited to moves within the particular building in which the resident resides, unless the resident voluntarily agrees to move to another of the composite distinct part's locations.

* * * * *

(b) * * *

(4) *Readmission to a composite distinct part.* When the nursing facility to which a resident is readmitted is a composite distinct part (as defined in § 483.5(c) of this subpart), the resident must be permitted to return to an available bed in the particular location of the composite distinct part in which he or she resided previously. If a bed is not available in that location at the time of readmission, the resident must be given the option to return to that location upon the first availability of a bed there.

* * * * *

§ 483.20 [Amended]

■ 3. In § 483.20(k)(1), the word ''describer'' is revised to read ''describe''.

PART 488—SURVEY, CERTIFICATION, AND ENFORCEMENT PROCEDURES

■ 1. The authority citation for part 488 continues to read as follows:

Authority: Secs. 1102 and 1871 of the Social Security Act (42 U.S.C. 1302 and 1395hh).

■ 2. In § 488.438, a new paragraph (d)(3) is added to read as follows:

§ 488.438 Civil money penalties: Amount of penalty.

* * * * *

(d) * * *

(3) Repeated deficiencies are deficiencies in the same regulatory grouping of requirements found at the last survey, subsequently corrected, and found again at the next survey.

* * * * *

PART 489—PROVIDER AGREEMENTS AND SUPPLIER APPROVAL

■ 1. The authority citation for part 489 continues to read as follows:

Authority: Secs. 1102 and 1871 of the Social Security Act (42 U.S.C. 1302 and 1395hh).

Subpart B—Essentials of Provider Agreements

■ 2. Section 489.20 is amended by:

■ A. Republishing the introductory text and paragraph (s) introductory text.

■ B. Revising paragraph (s)(12).

§ 489.20 Basic commitments.

The provider agrees to the following:

* * * * *

(s) In the case of an SNF, either to furnish directly or make arrangements (as defined in § 409.3 of this chapter) for all Medicare-covered services furnished to a resident (as defined in § 411.15(p)(3) of this chapter) of the SNF, except the following:

* * * * *

(12) Those chemotherapy items identified, as of July 1, 1999, by HCPCS codes J9000–J9020; J9040–J9151; J9170–J9185; J9200–J9201; J9206–J9208; J9211; J9230–J9245; and J9265–J9600; and, as of January 1, 2004, by HCPCS codes A9522 and A9523.

§ 489.22 [Amended]

■ 3. In § 489.22(d), the word ''impatient'' is removed, and the word ''inpatient'' is added in its place.

(Catalog of Federal Domestic Assistance Program No. 93.773, Medicare-Hospital Insurance Program; and No. 93.774, Medicare-Supplementary Medical Insurance Program)

Dated: July 10, 2003.

Thomas A. Scully,

Administrator, Centers for Medicare & Medicaid Services.

Dated: July 25, 2003.

Tommy G. Thompson,

Secretary.

[FR Doc. 03–19677 Filed 7–31–03; 8:45 am]

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CFR PARTS AFFECTED DURING AUGUST

At the end of each month, the Office of the Federal Register publishes separately a List of CFR Sections Affected (LSA), which lists parts and sections affected by documents published since the revision date of each title.

REMINDERS

The items in this list were editorially compiled as an aid to Federal Register users. Inclusion or exclusion from this list has no legal significance.

RULES GOING INTO EFFECT AUGUST 4, 2003

ENVIRONMENTAL PROTECTION AGENCY

Air quality implementation plans:
- Preparation, adoption, and submittal—
  - Regional haze rule; Western States and eligible Indian Tribes; sulfur dioxide milestones and backstop emissions trading program; published 6-5-03

Air quality implementation plans; approval and promulgation; various States:
- California; published 6-3-03
- District of Columbia; published 6-5-03
- Maryland; published 6-3-03
- Minnesota; published 6-5-03
- Pennsylvania; published 6-3-03
- Tennessee; published 6-3-03
- West Virginia; published 6-3-03

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Radio stations; table of assignments:
- Louisiana and Texas; published 7-7-03
- Texas; published 7-7-03

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- Commodities underlying derivative contracts; title delivery; published 7-3-03
  - Correction; published 7-16-03

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Practice and procedure:
- General application rules, safeguard investigations, and antidumping and countervailing duty investigations and reviews; technical corrections, etc.; published 6-3-03

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- Digital performance of sound recordings by preexisting subscription services; reasonable rates and terms determination; published 7-3-03

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- Boeing; published 7-18-03

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- Golden parachute payments; published 8-4-03

TREASURY DEPARTMENT

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- Revision; published 7-3-03

COMMENTS DUE NEXT WEEK

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Animal and Plant Health Inspection Service

Exportation and importation of animals and animal products:
- Cattle from Mexico; importation into U.S. prohibited due to tuberculosis; comments due by 8-4-03; published 6-3-03 [FR 03-13838]

AGRICULTURE DEPARTMENT

Forest Service

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- Forest Land Enhancement Program; comments due by 8-8-03; published 6-9-03 [FR 03-14259]

AGRICULTURE DEPARTMENT

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Wheat; U.S. standards; comments due by 8-4-03; published 6-4-03 [FR 03-13772]

AGRICULTURE DEPARTMENT

Natural Resources Conservation Service

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- Technical service provider assistance; comments due by 8-8-03; published 7-9-03 [FR 03-17260]

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- National Fire Plan; implementation; comments due by 8-4-03; published 6-5-03 [FR 03-14108]

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  - Atlantic bluefin tuna; comments due by 8-8-03; published 7-10-03 [FR 03-17521]
  - Atlantic swordfish; comments due by 8-4-03; published 6-20-03 [FR 03-15690]
  - Swordfish and bluefin tuna; comments due by 8-4-03; published 7-15-03 [FR 03-17867]
- Magnuson-Stevens Act provisions—
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  - Domestic fisheries; exempted fishing permit applications; comments due by 8-4-03; published 7-18-03 [FR 03-18341]
  - Domestic fisheries; exempted fishing permit applications; comments due by 8-4-03; published 7-18-03 [FR 03-18342]
  - Domestic fisheries; exempted fishing permit applications; comments due by 8-5-03; published 7-21-03 [FR 03-18488]
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  - Pacific whiting; comments due by 8-4-03; published 7-18-03 [FR 03-18164]

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- Follow-on production contracts for products developed pursuant to prototype projects; comments due by 8-4-03; published 6-3-03 [FR 03-13536]

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- Deferred compensation and postretirement benefits other than pensions; comments due by 8-4-03; published 6-3-03 [FR 03-13859]
- Unsolicited proposals; comments due by 8-4-03; published 6-3-03 [FR 03-13860]

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- Blanket sales certificates; comments due by 8-6-03; published 7-7-03 [FR 03-16820]

Practice and procedure:
- Cash management programs; documentation requirements; comments due by 8-7-03; published 7-8-03 [FR 03-16819]

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- Iowa; comments due by 8-7-03; published 7-8-03 [FR 03-17101]

Air quality implementation plans:
- Preparation, adoption, and submittal—
  - Regional haze rule; Western States and Indian tribes; mobile source provisions; comments due by 8-4-03; published 7-3-03 [FR 03-16922]
  - Regional haze rule; Western States and Indian tribes; mobile source provisions; comments due by 8-4-

03; published 7-3-03 [FR 03-16923]

Air quality implementation plans; approval and promulgation; various States:

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Georgia; comments due by 8-8-03; published 7-9-03 [FR 03-17204]

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This is a continuing list of public bills from the current session of Congress which have become Federal laws. It may be used in conjunction with ''P L U S'' (Public Laws Update Service) on 202–741–6043. This list is also available online at *http://www.nara.gov/fedreg/plawcurr.html*.

The text of laws is not published in the **Federal Register** but may be ordered in ''slip law'' (individual pamphlet) form from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402 (phone, 202–512–1808). The text will also be made available on the Internet from GPO Access at *http://www.access.gpo.gov/nara/nara005.html*. Some laws may not yet be available.

H.R. 74/P.L. 108–67

To direct the Secretary of Agriculture to convey certain land in the Lake Tahoe Basin Management Unit, Nevada, to the Secretary of the Interior, in trust for the Washoe Indian Tribe of Nevada and California. (Aug. 1, 2003; 117 Stat. 880)

S. 1280/P.L. 108–68

To amend the PROTECT Act to clarify certain volunteer liability. (Aug. 1, 2003; 117 Stat. 883)

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[1] Because Title 3 is an annual compilation, this volume and all previous volumes should be retained as a permanent reference source.

[2] The July 1, 1985 edition of 32 CFR Parts 1–189 contains a note only for Parts 1–39 inclusive. For the full text of the Defense Acquisition Regulations in Parts 1–39, consult the three CFR volumes issued as of July 1, 1984, containing those parts.

[3] The July 1, 1985 edition of 41 CFR Chapters 1–100 contains a note only for Chapters 1 to 49 inclusive. For the full text of procurement regulations in Chapters 1 to 49, consult the eleven CFR volumes issued as of July 1, 1984 containing those chapters.

[4] No amendments to this volume were promulgated during the period January 1, 2002, through January 1, 2003. The CFR volume issued as of January 1, 2002 should be retained.

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