Part A, Subpart III, Section 44701: General requirements.'' Under that section, Congress charges the FAA with promoting safe flight of civil aircraft in air commerce by prescribing regulations for practices, methods, and procedures the Administrator finds necessary for safety in air commerce. This regulation is within the scope of that authority because it addresses an unsafe condition that is likely to exist or develop on products identified in this rulemaking action.

Regulatory Findings

We determined that this AD will not have federalism implications under Executive Order 13132. This AD will not have a substantial direct effect on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government.

For the reasons discussed above, I certify this AD:

(1) Is not a ''significant regulatory action'' under Executive Order 12866,

(2) Is not a ''significant rule'' under the DOT Regulatory Policies and Procedures (44 FR 11034, February 26, 1979),

(3) Will not affect intrastate aviation in Alaska to the extent that it justifies making a regulatory distinction, and

(4) Will not have a significant economic impact, positive or negative, on a substantial number of small entities under the criteria of the Regulatory Flexibility Act.

We prepared a regulatory evaluation of the estimated costs to comply with this AD and placed it in the AD docket.

List of Subjects in 14 CFR Part 39

Air transportation, Aircraft, Aviation safety, Incorporation by reference, Safety.

Adoption of the Amendment

Accordingly, under the authority delegated to me by the Administrator, the FAA amends 14 CFR part 39 as follows:

PART 39—AIRWORTHINESS DIRECTIVES

■ 1. The authority citation for part 39 continues to read as follows:

Authority: 49 U.S.C. 106(g), 40113, 44701.

§ 39.13 [Amended]

■ 2. The FAA amends § 39.13 by adding the following new airworthiness directive (AD):

2013–26–10 Rolls-Royce plc: Amendment 39–17719; Docket No. FAA–2013–1004; Directorate Identifier 2013–NE–34–AD.

(a) Effective Date

This AD is effective January 23, 2014.

(b) Affected ADs

None.

(c) Applicability

This AD applies to all Rolls-Royce plc (RR) RB211–524G2–19, RB211–524G3–19, RB211–524H–36, and RB211–524H2–19 turbofan engines with high-pressure (HP) compressor rotor stage 1 and stage 2 discs, part number LK70608, LK76030, LK86621, UL19877, UL19878, UL19879, or UL24023, installed.

(d) Reason

This AD was prompted by a review by RR of the cyclic life of critical-life-limited parts (LLPs) for RB211–524 series engines. We are issuing this AD to prevent the failure of certain LLPs, which could result in uncontained engine damage and damage to the airplane.

(e) Actions and Compliance

Comply with this AD within the compliance times specified, unless already done.

(1) Within 30 days after the effective date of this AD, reduce the cyclic life limit for the affected HP compressor rotor stage 1 and stage 2 discs to 7,390 flight cycles (FC).

(2) After the effective date of this AD, remove each affected HP compressor rotor stage 1 and stage 2 disc from service before the part exceeds 7,390 FC.

(3) After the effective date of this AD, do not return to service any engine that has an HP compressor rotor stage 1 and stage 2 disc installed, if the disc has more than 7,390 FC.

(f) Alternative Methods of Compliance (AMOCs)

The Manager, Engine Certification Office, FAA, may approve AMOCs to this AD. Use the procedures found in 14 CFR 39.19 to make your request.

(g) Related Information

(1) For more information about this AD, contact Robert Green, Aerospace Engineer, Engine Certification Office, FAA, Engine & Propeller Directorate, 12 New England Executive Park, Burlington, MA 01803; phone: 781–238–7754; fax: 781–238–7199; email: *robert.green@faa.gov.*

(2) Refer to MCAI European Aviation Safety Agency AD 2013–0246, dated October 10, 2013, for more information. You may examine the MCAI in the AD docket on the Internet at *http://www.regulations.gov* by searching for and locating it in Docket No. FAA–2013–1004.

(h) Material Incorporated by Reference

None.

Issued in Burlington, Massachusetts, on December 23, 2013.

Carlos A. Pestana,

Acting Assistant Directorate Manager, Engine & Propeller Directorate, Aircraft Certification Service.

[FR Doc. 2014–00083 Filed 1–7–14; 8:45 am]

BILLING CODE 4910–13–P

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 239, 270, and 274

[Release Nos. 33–9506; IC–30847; File No. S7–7–11]

RIN 3235–AL02

Removal of Certain References to Credit Ratings Under the Investment Company Act

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission (''Commission'') is adopting amendments to a rule and three forms under the Investment Company Act of 1940 (''Investment Company Act'') and the Securities Act of 1933 (''Securities Act'') in order to implement a provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act (''Dodd-Frank Act''). Specifically, rule 5b–3 under the Investment Company Act contains a reference to credit ratings in determining when an investment company (''fund'') may treat a repurchase agreement as an acquisition of securities collateralizing the repurchase agreement for certain purposes under the Investment Company Act. The amendments we are adopting today replace this reference to credit ratings with an alternative standard designed to retain a similar degree of credit quality to that in current rule 5b–3. The Commission is also adopting amendments to Forms N–1A, N–2, and N–3 under the Investment Company Act and Securities Act to eliminate the required use of NRSRO credit ratings when a fund chooses to depict its portfolio holdings by credit quality.

DATES: *Effective Date:* February 7, 2014; *Compliance Date:* July 7, 2014.

FOR FURTHER INFORMATION CONTACT: Adam Bolter, Senior Counsel, Thoreau Bartmann, Branch Chief, or C. Hunter Jones, Assistant Director (202) 551–6792, Office of Investment Company Rulemaking, Division of Investment Management, Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549–8549.

SUPPLEMENTARY INFORMATION: The Commission is adopting amendments to rule 5b–3 [17 CFR 270.5b–3] under the Investment Company Act.[1] The

[1] 15 U.S.C. 80a. Unless otherwise noted, all references to statutory sections are to the Investment Company Act, and all references to rules under the Investment Company Act are to

Commission is also adopting amendments to Forms N–1A [17 CFR 239.15A and 17 CFR 274.11A], N–2 [17 CFR 239.14 and 17 CFR 274.11a–1], and N–3 [17 CFR 239.17a and 17 CFR 274.11b] under the Investment Company Act and the Securities Act.[2]

Table of Contents

I. Background

The first use of a reference to ratings or rating agencies in Commission rules was in 1975, when the Commission adopted the term ''nationally recognized statistical rating organization'' (''NRSRO'') as part of amendments to the net capital rule for broker-dealers, rule 15c3–1 under the Securities Exchange Act of 1934 (''Exchange Act'') (the ''Net Capital Rule'').[3] The Commission eventually included references to credit ratings issued by NRSROs in other rules under the securities laws, including the Investment Company Act.[4] In addition, credit ratings by NRSROs have been used as benchmarks in federal and state legislation, rules administered by other federal agencies, and foreign regulatory schemes.[5] Even prior to the enactment of the Dodd-Frank Act,[6] concerns about the wide-spread use of NRSRO credit ratings in statutes and regulations prompted the Commission to explore whether to eliminate references to credit ratings in Commission rules because of the potential overreliance by investors and, investment advisers and other financial professionals on these ratings, and whether there are practical alternatives to NRSRO credit ratings that could be used as benchmarks in regulations.[7]

Section 939A of the Dodd-Frank Act requires each Federal agency, including the Commission, to ''review any regulation issued by such agency that requires the use of an assessment of the credit-worthiness of a security or money market instrument and any references to or requirements in such regulations regarding credit ratings.'' [8] That section further provides that each such agency shall ''modify any such regulations identified by the review . . . to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations.'' [9]

As a step toward implementing these mandates, in March 2011 the Commission proposed to replace references to ratings issued by NRSROs in two Commission rules and four Commission forms under the Investment Company Act, including rule 5b–3 and Forms N–1A, N–2, and N–3.[10] We received 26 comment letters on the proposed rule and form amendments.[11] Several commenters addressed specific provisions of the proposal to amend rule 5b–3 and Forms N–1A, N–2, and N–3, which we discuss in more detail below.

We are adopting, largely as proposed, amendments to rule 5b–3 and Forms N–1A, N–2, and N–3 to implement section 939A of the Dodd-Frank Act and effectuate Congressional intent to reduce reliance on NRSRO credit ratings.[12] As discussed below, the amendments replace a reference to required NRSRO credit ratings in rule 5b–3 for certain securities held by funds as collateral for repurchase agreements with an alternative standard that is designed to retain a similar degree of credit quality. We are also amending Forms N–1A, N–2, and N–3 to eliminate the required use of NRSRO credit ratings by funds that choose to use credit quality categorizations in the required table, chart, or graph of portfolio holdings. Under the amendments, funds that choose to use credit quality to depict portfolio holdings must include a description of how the credit quality of the holding was determined. If a fund chooses to use credit ratings issued by a credit rating agency to depict the credit quality of portfolio holdings, the fund must

Title 17, Part 270 of the Code of Federal Regulations [17 CFR part 270].

[2] 15 U.S.C. 77a.

[3] *See* Adoption of Uniform Net Capital Rule and an Alternative Net Capital Requirement for Certain Brokers and Dealers, Exchange Act Release No. 11497 (June 26, 1975) [40 FR 29795 (July 16, 1975)]; 17 CFR 240.15c3–1. The Net Capital Rule prescribes minimum net capital requirements for broker-dealers and it uses NRSRO credit ratings to determine the amount of the charge to capital a broker-dealer must apply to certain types of debt instruments. *See* 17 CFR 240.15c3–1. The regulatory purpose was to provide a method for determining net capital charges on different grades of debt securities under the Net Capital Rule. *See* 17 CFR 240.15c3–1.

[4] *See, e.g.,* Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies, Investment Company Act Release No. 14983 (Mar. 12, 1986) [51 FR 9773 (Mar. 21, 1986)] (incorporating the concept of NRSROs into the definition of ''eligible security'' in rule 2a–7 (governing money market funds)).

[5] *See, e.g.,* Report to Congress on Credit Ratings, Board of Governors of the Federal Reserve System (July 2011); References to Credit Ratings in FDIC Regulations, Federal Deposit Insurance Corporation (July 2011); and Basel Committee on Banking Supervision, Stocktaking on the use of credit ratings, Joint Forum (June 2009).

[6] *See* Public Law 111–203, 124 Stat. 1376 (2010).

[7] *See infra* section II.A (discussing other Commission actions to remove references to credit ratings from its rules). *See also infra* section II.B (discussing actions of other regulators to remove references to credit ratings from their rules).

[8] Public Law 111–203, sec. 939A(a)(1)–(2). Section 939A of the Dodd-Frank Act applies to all federal agencies.

[9] Public Law 111–203, sec. 939A(b).

[10] *See* References to Credit Ratings in Certain Investment Company Act Rules and Forms, Investment Company Act Release No. 29592 (Mar. 3, 2011) [76 FR 12896 (Mar. 9, 2011)] (''2011 Proposing Release''). Specifically, we proposed to: (i) Remove references to credit ratings in rules 2a–7 and 5b–3 under the Investment Company Act and replace them with alternative standards of creditworthiness; (ii) adopt new rule 6a–5 under the Investment Company Act that would establish a creditworthiness standard to replace the credit rating reference in section 6(a)(5) removed by the Dodd-Frank Act; (iii) eliminate required disclosures of credit ratings in Form N–MFP; and (iv) remove the requirement that credit ratings be used when portraying credit quality in shareholder reports from Forms N–1A, N–2, and N–3. The Commission adopted new rule 6a–5 on November 19, 2012 and noted in its 2013 proposing release for money market reform that the Commission would address references to credit ratings in rule 2a–7 and Form N–MFP in a separate rulemaking. *See* Purchase of Certain Debt Securities by Business and Industrial Development Companies Relying on an Investment Company Act Exemption, Investment Company Act Release No. 30268 (Nov. 19, 2012) [77 FR 70117 (Nov. 23, 2012)]; Money Market Fund Reform; Amendments to Form PF, Investment Company Act Release No. 30551 (June 5, 2013) [78 FR 36834 (June 19, 2013)]. Rule 3a–7 under the Investment Company Act also contains a reference to ratings. In August 2011, in a concept release soliciting comment on the treatment of asset-backed issuers under the Investment Company Act, we sought comment on the role, if any, that credit ratings should continue to play in the context of rule 3a–7. *See* Treatment of Asset-Backed Issuers under the Investment Company Act, Investment Company Act Release No. 29779 (Aug. 31, 2011) [76 FR 55308 (Sept. 7, 2011)] at section III.A.1.

[11] Most of these commenters criticized removing credit ratings from rule 2a–7, but acknowledged that the Commission's proposal was in response to the mandate in the Dodd-Frank Act. The Commission plans to address these comments in a future rulemaking. *See supra* note 10. The comment letters on the 2011 Proposing Release (File No. S7–07–11) are available at *http://www.sec.gov/comments/s7-07-11/s70711.shtml.* In addition, to facilitate public input on the Dodd-Frank Act, we provided a series of email links, organized by topic on our Web site at *http://www.sec.gov/spotlight/regreformcomments.shtml.* The public comments we received on section 939A of the Dodd-Frank Act are available on our Web site at *http://www.sec.gov/comments/df-title-ix/credit-rating-agencies/credit-rating-agencies.shtml.*

[12] *See* Section 939A of the Dodd-Frank Act. Section 939A was intended, at least in part, to address potential over-reliance on NRSRO credit ratings resulting from perceived government-endorsement of NRSROs. *See* Report of the House of Representatives Financial Services Committee to Accompany H.R. 4173, H. Rep. No. 111–517 at 871 (2010).

include a description of how the credit ratings were identified and selected.

In a separate release, the Commission is adopting final amendments to remove references to credit ratings from rules on broker-dealer financial responsibility and confirmations of transactions. These amendments follow the Commission's April 2011 proposed rules in which we proposed to amend rules and one form under the Exchange Act applicable to broker-dealer financial responsibility, distributions of securities, and confirmations of transactions in order to remove references to credit ratings pursuant to section 939A of the Dodd-Frank Act.[13]

II. Prior Actions of the Commission and Other Regulators

As part of our implementation of section 939A, we have reviewed our prior actions and those of other regulators. As discussed below, both the Commission and other regulators have proposed and issued several final rules towards implementation of the mandate under section 939A of the Dodd-Frank Act. In some cases, the references to credit ratings were replaced with an alternative standard of credit quality designed to retain the same degree of credit quality and liquidity as reflected by the use of credit ratings.

A. Prior Commission Actions

The Commission has long been concerned with the use of credit ratings and has taken a variety of actions even before the enactment of the Dodd-Frank Act regarding the use of NRSRO credit ratings in its rules. For example, in 1994, the Commission published a concept release soliciting comment on, among other things, whether the Commission should eliminate references to NRSRO credit ratings from certain rules.[14] The Commission continued to consider the use of credit ratings in its rules, when in 2003, we sought comment on alternative benchmarks that could be used to meet the Commission's regulatory objectives.[15] Finally, in 2008, the Commission proposed amendments to remove references to NRSRO credit ratings from certain of its rules under the Securities Act, Exchange Act, and Investment Company Act.[16] As previously noted, after the enactment of the Dodd-Frank Act, in 2011, the Commission proposed to remove credit ratings references from certain rules and forms under the Investment Company Act.[17] Also in 2011, the Commission separately proposed and adopted amendments removing references to credit ratings in rules and forms under the Securities Act and the Exchange Act related to offerings of securities or issuer disclosure.[18] Generally, in these prior actions, the Commission has proposed or adopted amendments to its rules that seek to retain a similar degree of credit quality to that in the rule being amended by replacing credit ratings references with a two-part standard that includes an assessment of the credit quality and the liquidity of the security, the details of which vary according to the requirements of the particular rule or form.

B. Actions of Other Regulators

A number of other federal agencies have also taken action to implement section 939A of the Dodd-Frank Act, including regulations proposed or adopted by the Commodity Futures Trading Commission (''CFTC''),[19] the Office of the Comptroller of the Currency (''OCC''),[20] the National Credit Union Administration (''NCUA''),[21] the Federal Housing Finance Agency (''FHFA''),[22] the Department of Labor (''DOL''),[23] and jointly by the OCC and Federal Reserve Board (''FRB'').[24] The actions taken by these other regulators were considered in adopting today's amendments.

III. Discussion

A. Rule 5b–3

Rule 5b–3 allows funds to treat the acquisition of a repurchase agreement as an acquisition of securities collateralizing the repurchase agreement for certain diversification and broker-dealer counterparty limit purposes under the Investment Company Act[25] if

[13] *See* Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, Exchange Act Release No. 64352 (Apr. 27, 2011) [76 FR 26550 (May 6, 2011)] (requesting public comment on proposed amendments to rule 15c3–1 (17 CFR 240.15c3–1), rule 15c3–3 (17 CFR 240.15c3–3), rule 17a–4 (17 CFR 240.17a–4), rules 101 and 102 of Regulation M (17 CFR 242.101 and 242.102), and rule 10b–10 (17 CFR 240.10b–10), and one form—the General Instructions to Form X–17A–5, Part IIB (17 CFR 249.617)—to remove references to credit ratings and, in certain cases, substitute alternative standards of creditworthiness). For purposes of implementing section 939(e) of the Dodd-Frank Act, which eliminated provisions in sections 3(a)(41) and 3(a)(53)(A) of the Exchange Act that referenced NRSRO credit ratings, the Commission also requested comment in the proposing release on potential standards of creditworthiness to replace the credit rating references.

[14] *See* Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34616 (Aug. 31, 1994) [59 FR 46314 (Sep. 7, 1994)]; *see also* Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, Exchange Act Release No. 39457 (Dec. 17, 1997) [62 FR 68018 (Dec. 30, 1997)].

[15] *See* Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws, Exchange Act Release No. 47972 (June 4, 2003) [68 FR 35258 (June 12, 2003)]; *see also* Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets: As Required by Section 702(b) of the Sarbanes-Oxley Act of 2002, Commission (Jan. 2003).

[16] *See, e.g.,* References to Ratings of Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 58070 (July 1, 2008) [73 FR 40088 (July 11, 2008)]. In October 2009, the Commission adopted several of the 2008 proposed amendments and re-opened for comment the remaining amendments. *See* References to Ratings of Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 60789 (Oct. 5, 2009) [74 FR 52358 (Oct. 9, 2009)] (adopting release).

[17] *See* 2011 Proposing Release *supra* note 10. One aspect of that rule proposal has already been adopted. New rule 6a–5, adopted by the Commission, replaced a credit rating requirement (removed by Congress as part of the Dodd-Frank Act) applicable to debt securities that certain business and industrial development companies (''BIDCOs'') relying on the Investment Company Act exemption in section 6(a)(5) may invest in. Under new rule 6a–5, a BIDCO that relies on the exemption in section 6(a)(5) may invest in certain debt securities, provided that the BIDCO board determines, at the time of purchase, that the debt security is (1) of no greater than moderate credit risk and (2) is sufficiently liquid. The standard for liquidity is whether the security can be sold at or near its carrying value within a reasonably short period of time. *See* Purchase of Certain Debt Securities by Business and Industrial Development Companies Relying on an Investment Company Act Exemption, Investment Company Act Release No. 30268 (Nov. 19, 2012) [77 FR 70117 (Nov. 23, 2012)].

[18] *See* Security Ratings, Securities Act Release No. 9186 (Feb. 9, 2011) [76 FR 8946 (Feb. 16, 2011)]; *see also* Security Ratings, Securities Act Release No. 9245 (July 27, 2011) [76 FR 46603 (Aug. 3, 2011)] (adopting amendments to rule 134 (17 CFR 230.134), rule 138 (17 CFR 230.138), rule 139 (17 CFR 230.139), rule 168 (17 CFR 230.168), Form S–3 (17 CFR 239.13), Form S–4 (17 CFR 239.25), Form F–3 (17 CFR 239.33), and Form F–4 (17 CFR 230.34) under the Securities Act; rescinding Form F–9 (17 CFR 239.39); adopting amendments to the Securities Act and Exchange Act forms and rules that referred to Form F–9 to eliminate those references; and amending Schedule 14A (17 CFR 240.14a–101) under the Exchange Act).

[19] CFTC, Removing Any Reference to or Reliance on Credit Ratings in Commission Regulations; Proposing Alternatives to the Use of Credit Ratings, 76 FR 44262 (July 25, 2011).

[20] OCC, Alternatives to the Use of External Credit Ratings in the Regulations of the OCC, 77 FR 35253 (June 13, 2012).

[21] NCUA, Alternatives to the Use of Credit Ratings, 77 FR 74103 (Dec. 13, 2012).

[22] FHFA, Removal of References to Credit Ratings in Certain Regulations Governing the Federal Home Loan Banks, 78 FR 30784 (May 23, 2013).

[23] DOL, Proposed Amendments to Class Prohibited Transaction Exemptions to Remove Credit Ratings Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, 78 FR 37572 (June 21, 2013).

[24] OCC & FRB, Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 FR 62018 (Oct. 11, 2013).

[25] Section 5(b)(1) of the Investment Company Act limits the amount that a fund that holds itself out as being a diversified investment company may

the obligation of the seller to repurchase the securities from the fund is ''collateralized fully.'' [26] In a typical investment company repurchase agreement, a fund enters into a contract with a broker, dealer, or bank (the ''counterparty'' to the transaction) to purchase securities. The counterparty agrees to repurchase the securities at a specified future date, or on demand, for a price that is sufficient to return to the fund its original purchase price, plus an additional amount representing a return to the fund on its investment. Economically, a repurchase agreement functions as a loan from the fund to the counterparty, in which the securities purchased by the fund serve as collateral for the loan.[27]

Under current requirements, a repurchase agreement is collateralized fully if, among other things, the collateral for the repurchase agreement consists entirely of (i) cash items, (ii) government securities,[28] (iii) securities that at the time the repurchase agreement is entered into are rated in the highest rating category by the ''requisite NRSROs'' [29] or (iv) unrated securities that are of a comparable quality to securities that are rated in the highest rating category by the requisite NRSROs, as determined by the fund's board of directors or its delegate.[30] When the Commission proposed rule 5b-3, we explained that the highest rating category requirement in the definition of fully collateralized was designed to help ensure that the market value of the collateral would remain stable and that the fund could liquidate the collateral quickly in the event of a default by the counterparty. The high quality requirement was also designed to limit a fund's exposure to the ability of the counterparty to maintain sufficient collateral, and reflected the understanding that securities of lower quality may be subject to greater price fluctuation.[31]

Today we are amending rule 5b–3 to eliminate the requirement that collateral other than cash or government securities be rated in the highest category by the requisite NRSROs or be of comparable quality. In place of this requirement, the amended rule requires that collateral other than cash or government securities consist of securities that the fund's board of directors (or its delegate) determines at the time the repurchase agreement is entered into are: (i) Issued by an issuer that has an exceptionally strong capacity to meet its financial obligations on the securities collateralizing the repurchase agreement; and (ii) sufficiently liquid that they can be sold at approximately their carrying value in the ordinary course of business within seven calendar days.[32]

The new credit quality standard we are adopting is designed to retain a degree of credit quality that is similar to the existing standard under rule 5b–3 and consistent with the two-part approach we have taken in establishing credit quality standards to replace credit rating references in other rules under the federal securities laws.[33] We note that our amendment to rule 5b–3 does not affect a money market fund that seeks special treatment of its repurchase agreement holdings under the diversification provisions of rule 2a–7 because in order to obtain such treatment, a money market fund is limited to investing in repurchase agreements collateralized by cash items or government securities (which remain unaffected by our amendments today).[34] We are adopting the liquidity component of the new standard as proposed, but we have revised the credit quality component from what was proposed to address certain commenters' concerns.

We proposed that collateral issuers be required to have the ''highest capacity'' to meet their financial obligations on the collateral securities.[35] Three of the five commenters who addressed the proposed amendments to rule 5b–3 argued that this standard is not consistent with the standard established by the ratings reference in the current rule because the proposed standard does not contemplate any variation in creditworthiness among issuers that meet the highest rating standard.[36] Commenters suggested that short-term collateral securities rated ''A–1+'' or ''A–1'' by Standard & Poor's both would satisfy the rating condition under the current rule, but that only those rated ''A–1+'' would likely have satisfied the credit standard under our proposal.[37] Accordingly, as these commenters recommended, the amended rule requires an issuer to have an ''exceptionally strong'' capacity to meet its financial obligations on the collateral securities.[38] We are adopting this

invest in the securities of any one issuer (other than the U.S. Government). This provision may limit the number and principal amounts of repurchase agreements that a diversified fund may enter into with any one counterparty. Section 12(d)(3) of the Investment Company Act generally prohibits a fund from acquiring an interest in a broker, dealer, or underwriter. Because a repurchase agreement may be considered to be the acquisition of an interest in the counterparty, section 12(d)(3) may limit a fund's ability to enter into repurchase agreements with many of the firms that act as repurchase agreement counterparties. Rule 12d3–1 provides an exemption from the prohibitions of section 12(d)(3) under certain conditions, which exemption a fund may be able to rely on in the event the repurchase agreement fails to meet the look-through requirements of rule 5b–3. *See* Rule 5b–3 Adopting Release, *infra* note 27, at section II.C. The ability of funds to rely on rule 5b–3 of the Investment Company Act may affect the degree to which a fund invests in repurchase agreements.

[26] Rule 5b–3(a). The term ''collateralized fully'' is defined in rule 5b–3(c)(1). In general, under rule 5b–3, a fund investing in a repurchase agreement looks to the value and liquidity of the securities collateralizing the repurchase agreement rather than the creditworthiness of the counterparty for satisfaction of the repurchase agreement. *See* Rule 5b–3 Adopting Release, *infra* note 27, at section II.A.3. *But see* rule 2a–7(c)(4)(ii)(A) (requiring money market fund boards to evaluate the counterparty's creditworthiness).

[27] *See* Treatment of Repurchase Agreements and Refunded Securities as an Acquisition of the Underlying Securities, Investment Company Act Release No. 25058 (July 5, 2001) [66 FR 36156 (July 11, 2001)] (''Rule 5b–3 Adopting Release''). Repurchase agreements provide funds with a convenient means to invest excess cash on a secured basis, generally for short periods of time.

[28] Government Security means ''any security issued or guaranteed as to principal or interest by the United States, or by a person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States; or any certificate of deposit for any of the foregoing.'' Section 2(a)(16) of the Investment Company Act. Government securities include, for example, U.S. Treasury notes and bonds, and securities issued by the Federal Home Loan Mortgage Company (''Freddie Mac''), Federal National Mortgage Association (''Fannie Mae''), and Government National Mortgage Association (''Ginnie Mae'').

[29] The term ''requisite NRSROs'' means any two NRSROs that have issued a rating with respect to a security or class of debt obligations of an issuer or, if only one NRSRO has issued a rating with respect to such security or class of debt obligations of an issuer at the time the investment company acquires the security, that NRSRO. Rule 5b–3(c)(6). This definition is deleted under the amended rule.

[30] Rule 5b–3(c)(1)(iv). The term ''unrated securities'' means securities that have not received a rating from the requisite NRSROs. Rule 5b–3(c)(8). This definition is deleted under the amended rule.

[31] *See* Treatment of Repurchase Agreements and Refunded Securities as an Acquisition of the Underlying Securities, Investment Company Act Release No. 24050 (Sept. 23, 1999) [64 FR 52476 (Sept. 29, 1999)] (''Rule 5b–3 Proposing Release'') at n.43 and accompanying text.

[32] Amended rule 5b–3(c)(1)(iv)(C).

[33] *See supra* section II.A.

[34] *See* rule 2a–7(a)(5).

[35] *See* proposed rule 5b–3(c)(1)(iv)(C)(1).

[36] Federated Investors, Inc. Comment Letter (Apr. 25, 2011) (''Federated Comment Letter''); Investment Company Institute Comment Letter (Apr. 25, 2011) (''ICI Comment Letter''); T. Rowe Price Associates, Inc. Comment Letter (Apr. 25, 2011) (''T. Rowe Price Comment Letter''). *But see* 2011 Proposing Release (discussing the proposed ''highest capacity'' standard and noting that ''[a]n issuer of collateral securities that the board (or its delegate) determined has an exceptionally strong capacity to repay its short or long-term debt obligations . . . would satisfy the proposed [highest capacity] standard'').

[37] *See* Standard & Poor's Ratings Definitions, *infra* note 39 at 5 (which may designate an ''A–1'' rating with a plus sign to designate the obligor's capacity to meet its financial obligations is extremely strong).

[38] *See* ICI Comment Letter; Federated Comment Letter (supporting the ICI Comment Letter); and T.

Continued

standard, as revised from our proposal, because we believe that, like the current rule, it permits some variation in creditworthiness among issuers while being designed to retain a degree of risk limitation similar to the current rule.[39] In the case of asset-backed securities that serve as collateral, an evaluation of the capacity of the issuer to meet its financial commitment on the security should include an assessment of the quality of the underlying assets and the structure of the asset-backed security.[40]

As discussed above, we are adopting the liquidity component of the new standard as proposed. The liquidity standard in the amended rule is similar to the standard used in rule 2a–7 governing money market funds, and is also used in other rules under the Investment Company Act.[41] No commenters addressed the proposed liquidity standard.

We expect that securities that actively trade in a secondary market at the time of the acquisition of the repurchase agreement will satisfy the liquidity component of the standard. We also understand that most securities used to collateralize repurchase agreements generally actively trade in a secondary market.[42] Securities that do not actively trade in a secondary market would likely require a more in-depth evaluation by the board or its delegate to determine whether they meet the liquidity standard.

The final amendments do not, as one commenter suggested, include specific factors or tests that the board or its delegate must apply in performing its credit analysis.[43] This commenter acknowledged that a reliable and objective shorthand measure of credit risk that could be incorporated into Commission regulations is currently unavailable.[44] The Commission considered including specific factors for funds to consider in performing credit analysis under rule 5b–3. On balance, we believe that, in the context of rule 5b–3, the new credit quality standards provide sufficiently clear criteria under which a fund board or its delegate can make determinations regarding credit quality and liquidity for this particular purpose. Fund boards should also be familiar with applying similar credit quality standards used in other Commission rules.[45] Fund boards may also consult external resources and Commission staff guidance (if applicable) for additional guidance on making credit quality determinations in certain circumstances.[46]

The new credit quality standard is intended to achieve the same objectives that the credit rating requirement was designed to achieve, *i.e.,* to limit collateral securities to those that are likely to retain a sufficiently stable market value and that, under ordinary circumstances, the fund would be able to liquidate quickly, at or near their carrying value in the event of a counterparty default.[47] Amended rule 5b–3 would not, however, prohibit a fund board from establishing its own additional criteria for what the fund may accept as collateral for repurchase agreements under the amended rule.

Under the final rule, as was proposed, the fund's board will be required to make credit quality determinations for all collateral securities that are not cash items or government securities, rather than just for unrated securities. In addition, as in the current rule, the amended rule continues to permit the board to delegate these credit quality and liquidity determinations.[48] We do not agree with the concerns of one commenter that this determination will impose undue burdens on the board because the determination is similar to what rule 5b–3 currently requires a fund board (or its delegate) to make with respect to unrated collateral securities.[49] In addition, the amended rule will continue to permit the board of directors to delegate credit quality and liquidity determinations that the board believes

Rowe Price Comment Letter (generally agreeing with the ICI Comment Letter).

[39] *See* Fitch Ratings, International Issuer and Credit Rating Scales, *http://www.fitchratings.com/web_content/ratings/fitch_ratings_definitions_and_scales.pdf* (stating that a rating of AAA is used in cases of ''exceptionally strong capacity for payment of financial commitments''); Moody's Investor Service Rating Symbols and Definitions, *https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004* (stating that ratings of Aaa are of the ''highest quality, subject to the lowest level of credit risk''); and Standard & Poor's Ratings Definitions, *http://img.en25.com/Web/StandardandPoors/Ratings_Definitions.pdf* (stating that for a rating of AAA, ''[t]he obligor's capacity to meet its financial commitment on the obligation is extremely strong'').

[40] *See* Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 19959 (Dec. 17, 1993) [58 FR 68585 (Dec. 28, 1993)] at text accompanying nn.108–109 (''[t]he credit quality of a typical asset backed security depends both upon the structure of the security and the quality of the underlying assets.''); Money Market Fund Reform, Investment Company Act Release No. 29132 (Feb. 23, 2010) [75 FR 10060 (Mar. 4, 2010)] at text accompanying n.131 (noting that the minimal credit risk analysis that a money market fund board (or its delegate) must conduct before investing in an asset-backed security should include, among other things, (i) an analysis of the underlying assets to ensure they are properly valued and provide sufficient asset coverage for the cash flow required to fund the asset-backed security under various market conditions and (ii) an analysis of the terms of any liquidity or other support provided by the sponsor of the asset-backed security). *See also* Alternatives to the Use of External Credit Ratings in the Regulations of the Office of the Comptroller of the Currency (June 4, 2012) [77 FR 35253 (June 13, 2012)] at text following n.2 (in adopting an issuer-based credit quality standard to replace credit ratings, the OCC indicates that, in the case of a structured finance transaction, principal and interest repayment is not necessarily solely reliant on the direct debt repaying capacity of the issuer or obligor).

[41] *See* rule 2a–7(a)(19) (defining illiquid security to mean a security that cannot be sold or disposed of in the ordinary course of business within seven calendar days at approximately the value ascribed to it by the fund). *See also* rule 10f–3(a)(3) (requiring, among other things, that ''eligible municipal securities'' be sufficiently liquid that they can be sold at or near their carrying value within a reasonably short period of time).

[42] Repurchase agreements are often collateralized by securities that include, but are not limited to, agency collateralized mortgage-backed obligations (''CMOs''), agency debentures and strips, agency mortgage-backed securities, private label CMOs, corporate debt, equity securities, money market instruments and U.S. Treasury securities. *See, e.g.,* Tri-Party Repo Statistical Data (as of August 2013), *http://www.newyorkfed.org/banking/tpr_infr_reform_data.html.* The securities that often collateralize repurchase agreements trade frequently. For example, data from the Securities Industry and Financial Markets Association for January through August 2013 shows average daily trading volume, in billions of dollars, as follows: Agency debentures and strips ($7.1); agency mortgage-backed securities ($242.9); corporate debt ($145.4); U.S. Treasury securities ($551.4) (available at *http://www.sifma.org/research/statistics.aspx*).

[43] *See* Better Markets Comment Letter (Apr. 25, 2011) (''Better Markets Comment Letter''). This commenter suggested certain factors that they believed funds should be required to consider when evaluating the creditworthiness of an issuer or a debt security.

[44] *Id.* We note that another commenter that recommended that we establish an objective standard for credit quality determinations did not provide any examples of such criteria. *See* New York City Bar Committee on Investment Management Regulation Comment Letter (Apr. 29, 2011) (''NY City Bar Comment Letter'').

[45] *See* adopting release, *supra* note 16 (the Commission adopted amendments to rule 10f–3, revising the definition of ''eligible municipal security'' by replacing references to credit ratings with a similar two-part credit quality standard). *See also* text accompanying note 49.

[46] *See, e.g.,* Tri-Party Repo Infrastructure, Reform Task Force, *http://www.newyorkfed.org/tripartyrepo/. See cf.* Securities and Exchange Commission, Division of Investment Management, IM Guidance Update, *Counterparty Risk Management Practices With Respect to Tri-Party Repurchase Agreements* (July 2013) (providing guidance to funds on the legal and operational steps that funds should consider if a counterparty fails and defaults on its obligations under a tri-party repurchase agreement), available at *http://www.sec.gov/divisions/investment/guidance/im-guidance-2013-03.pdf.*

[47] *See supra* note 31.

[48] This is similar to rule 2a–7, which permits the board to delegate decisions regarding credit quality. *See* rule 2a–7(e).

[49] *See* NY City Bar Comment Letter (asserting that fund boards would be assigned responsibility for making determinations that are not within their expertise and arguing that the ability to delegate the determination does not relieve them of ultimate responsibility). *See also infra* section V.b.2. *See* rule 5b–3(c)(1)(iv)(D) (requiring that unrated securities other than government securities be ''of comparable quality'' to securities rated in the highest category by requisite NRSROs).

are within the delegate's expertise if the board retains sufficient oversight.[50]

Under the amended rule, when determining credit quality and liquidity, the board (or its delegate) may incorporate into its analysis ratings, reports, opinions and other assessments issued by third parties, including NRSROs. A board should evaluate the basis for using any third-party assessment, including an NRSRO rating, in determining whether collateral meets the new standard and would not rely on the use of an NRSRO rating as a standard by itself without evaluating the quality of each NRSRO's assessment. In this way, the board could determine which third-party providers are credible and reliable and provide assessments that would be most appropriate to incorporate in making determinations under the amended rule. Delegation of these functions, as well as the use of third-party providers, may help to limit the potential increase in burdens on the board. One commenter suggested that we not allow a fund board to consider credit ratings in determining if a repurchase agreement is fully collateralized, stating that this would conflict with section 939A of the Dodd-Frank Act.[51] We believe, however, that credit ratings can serve as a useful data point for evaluating credit quality, and as noted above, a fund's board (or its delegate) may not rely solely on the credit ratings of an NRSRO without performing additional due diligence.

A fund that enters into repurchase agreements and relies on rule 5b–3 must maintain written policies and procedures that are reasonably designed to comply with the conditions of the rule, including the credit quality and liquidity requirements we are adopting today, and funds may therefore have to amend their policies and procedures.[52] We also understand that credit quality standards for securities collateralizing repurchase agreements are typically negotiated in the agreements between funds and counterparties.[53] We understand that those standards currently include a rating (for rated collateral securities) and any additional criteria that a fund manager considers necessary to ensure that the credit quality of collateral securities meets the fund's requirements, or, for unrated securities, a comparable credit quality standard. The amended rule does not prohibit fund boards (or their delegates) from considering the credit quality standards in current repurchase agreements and policies and procedures adopted to comply with the current rule as part of their analysis, provided that fund boards (or their delegates) determine that the ratings specified in the repurchase agreements and policies and procedures meet the standards we are adopting today, and that the agencies providing the ratings used in the policies and procedures are credible and reliable for that use. A fund could also revise its repurchase agreements and policies and procedures to change or eliminate the consideration of specific credit ratings or to incorporate other third-party evaluations of credit quality.[54]

As discussed above, amended rule 5b–3 replaces the requirement that collateral for repurchase agreements consist of securities rated in the highest category by the requisite NRSROs (other than cash and government securities) with a requirement that the collateral other than cash and government securities consist of securities issued by an issuer that has an exceptionally strong capacity to meet its financial obligations and that are sufficiently liquid. Consistent with the protection of investors and as necessary and appropriate in the public interest, we are also amending rule 5b–3 to define an issuer to include an issuer of an unconditional guarantee of the security.[55] We proposed this amendment to preserve a fund's ability to use the same types of collateral securities as it currently uses to satisfy the conditions of rule 5b–3. We received no comments on this aspect of the proposal and are adopting it as proposed. Thus, under amended rule 5b–3, a collateral security with an unconditional guarantee, the issuer of which meets the new credit quality test, satisfies that element of the standard.

B. Forms N–1A, N–2, and N–3

We are also adopting amendments to Forms N–1A, N–2, and N–3 to remove the required use of credit ratings assigned by an NRSRO. Forms N–1A, N–2, and N–3, among other things, contain the requirements for shareholder reports of mutual funds, closed-end funds, and certain insurance company separate accounts that offer variable annuities.[56]

Currently, Forms N–1A, N–2, and N–3 require shareholder reports to include a table, chart, or graph depicting portfolio holdings by reasonably identifiable categories (*e.g.,* type of security, industry sector, geographic region, credit quality, or maturity).[57] The forms require the categories to be selected in a manner reasonably designed to depict clearly the types of investments made by the fund, given its investment objectives. If credit quality is used to present portfolio holdings, the forms currently require that credit quality be depicted using the credit ratings assigned by a single NRSRO. We are amending Forms N–1A, N–2, and N–3, as proposed, to no longer *require* the use of NRSRO credit ratings by funds that choose to use credit quality categorizations in the required table, chart, or graph of portfolio holdings. Accordingly, funds that choose to show credit quality categorizations in the required table, chart, or graph may use alternative categorizations that are not based on NRSRO credit ratings.

In a change from the 2011 Proposing Release, however, under the amended forms, funds that choose to continue to

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[50] *See* Amended rule 5b–3(c)(1)(iv)(C); *see also* 2011 Proposing Release, *supra* note 10, at n.51 ("As in the current rule, the proposed rule would permit the board to delegate this credit quality and liquidity determination."). We expect that a fund's written policies and procedures would include guidelines for the fund's delegate (typically, the investment adviser) in making required determinations under rule 5b–3 and oversight of the fund adviser's compliance in making such determinations. *See* rule 38a–1. These policies and procedures typically would identify the process to be followed by the board (or its delegate) in making these credit and liquidity evaluations, including, as appropriate, the types of data to be used or factors to be considered and the person(s) or position(s) responsible. They also typically would provide for regular reporting to the board, as appropriate, about these evaluations, to allow the board to provide effective oversight of the process.

[51] *See* Better Markets Comment Letter.

[52] Registered funds are required to adopt and implement written policies and procedures reasonably designed to prevent the fund's violation of federal securities laws. *See* rule 38a–1(a); *see also infra* sections IV.A and V.B.

[53] Many repurchase market participants will only accept AAA-rated paper such as government bonds as collateral. *See* Moorad Choudhry, The Repo Handbook (2d ed. 2010) at 298. Counterparties to repurchase agreements generally assess counterparty credit risk exposure based on the "haircut"—For example, $100 of securities collateralizing a loan of $97 produces a 3% haircut. The haircut may be greater depending on the counterparties' assessment of the collateral provider's creditworthiness. *See* Repo and Securities Lending, Staff Report No. 529, Federal Reserve Bank of New York (Dec. 2011, Rev. Feb. 2013). Assessments of credit quality are not standardized but are participant specific and negotiated at the time of the transaction. *Id.*

[54] *See* 2011 Proposing Release, *supra* note 10, at n.58. An estimate of the potential costs is discussed *infra* at section IV.A.

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

[56] Open-end management investment companies, commonly known as mutual funds, use Form N–1A. Closed-end management investment companies use Form N–2. Separate accounts organized as management investment companies that offer variable annuity contracts use Form N–3.

[57] Item 27(d)(2) of Form N–1A; Instruction 6(a) to Item 24 of Form N–2; Instruction 6(i) to Item 28(a) of Form N–3.

use credit ratings will no longer be restricted to using the credit ratings assigned by a single NRSRO. Accordingly, funds that choose to depict credit quality using credit ratings assigned by a credit rating agency may use different credit rating agencies for split-rated securities (*i.e.,* securities that have received different ratings from multiple credit rating agencies) and they may use ratings provided by credit rating agencies that are not NRSROs.[58] Funds will also be required to describe how the credit quality of the holdings was determined, and if credit ratings are used, a description of how they were identified and selected.[59]

Four of the five substantive comments we received on the proposed amendments to Forms N–1A, N–2, and N–3, supported eliminating the required use of NRSRO credit ratings to depict credit quality.[60] Two of these commenters noted that shareholders would benefit from information about the credit quality of a fund's portfolio securities, whether determined by an NRSRO or internally.[61]

Although most commenters supported eliminating the required use of credit ratings to depict credit quality, four commenters opposed the proposed requirement that a fund that chooses to use NRSRO credit ratings must use the credit ratings of a single NRSRO. Instead, these commenters recommended that when a security is split-rated, the fund be permitted to choose which NRSRO rating to use, provided the choice is made consistently pursuant to a disclosed policy.[62] These commenters argued that this approach would benefit funds and investors by allowing funds to disclose credit quality information in shareholder reports in a manner consistent with marketing materials and internal investment policies.[63]

We agree with commenters and have revised the final form amendments to provide this additional degree of flexibility. Accordingly, the amended forms permit funds to consider alternative approaches to presenting credit quality that accurately and effectively describe the credit quality of the fund's portfolio. For example, under the amended forms, a fund could have a policy of disclosing the median credit quality rating for split-rated securities instead of only using the ratings of a single credit rating agency (when more than two rating agencies rate the security).[64] In the 2011 Proposing Release, we proposed to maintain the general requirement that ratings be selected from a single NRSRO because we were concerned about the possibility that a fund may select the most favorable credit ratings among credit ratings assigned by multiple NRSROs. On balance, we are persuaded by commenters that the benefits of this additional flexibility outweigh the potential ''cherry picking'' concern. We believe that the risks associated with cherry picking ratings are mitigated by the disclosure requirements discussed below.[65] For example, if a fund discloses that, with respect to split-rated securities, it is the fund's policy to select the highest credit rating provided by a credit rating agency, investors will be on notice that the fund has made a decision not to include potentially lower and more conservative measures of credit quality. In addition, we believe that in some circumstances selecting credit ratings from more than one credit rating agency may reflect a more comprehensive approach to credit quality analysis that results in information about credit quality that may be more accurate or complete. For example, a fund that reviews credit ratings from three rating agencies, discards the outliers (*i.e.,* the highest and lowest ratings), and selects the middle rating,[66] has evaluated credit quality from a broader set of market participants that may lead to a more complete evaluation of credit quality.

Under the amended forms, funds that choose to depict portfolio holdings according to credit quality must include a description of how the credit quality of the holdings was determined.[67] This description should include a discussion of the credit quality evaluation process, the rationale for its selection, and an overview of the factors considered, such as the terms of the security (*e.g.,* interest rate, and time to maturity), the obligor's capacity to repay the debt, and the quality of any collateral. If the fund uses credit ratings issued by a credit rating agency to depict credit quality, the fund should explain how the credit ratings were identified and selected, and include this description near, or as part of, the graphical representation.[68] This description should include, if applicable, a discussion of: (i) The criteria considered or process used in selecting the credit ratings (*e.g.,* the fund might use the median credit rating from among three rating agencies[69]); (ii) how the fund evaluated those criteria (*i.e.,* the due diligence performed); (iii) how the fund reports credit ratings for any security that is not rated by the credit rating agency selected if the fund has a policy of using the ratings of a

58 We are replacing the term ''ratings'' with ''credit ratings'' and ''nationally recognized statistical rating organization 'NRSRO' '' with ''credit rating agency'' as defined under the Exchange Act. *See* sections 3(a)(60) [15 U.S.C. 78c(a)(60)] and 3(a)(61) [15 U.S.C. 78c(a)(61)] of the Exchange Act, which define ''credit rating'' and ''credit rating agency'', respectively.

59 *See* Amended Item 27(d)(2) of Form N–1A; Amended Instruction 6(a) to Item 24 of Form N–2; Amended Instruction 6(i) to Item 28(a) of Form N–3.

60 ICI Comment Letter; Vanguard Comment Letter; T. Rowe Price Comment Letter; Federated Comment Letter (supporting the ICI's comments). The fifth commenter argued that the Commission is not required to remove references to credit ratings from the forms pursuant to section 939A of the Dodd-Frank Act. *See* BlackRock Comment Letter. Regardless of whether the Commission is required to remove from the forms references to credit ratings, the Commission believes that the removal of such references is consistent with the purpose of section 939A of the Dodd-Frank Act.

61 ICI Comment Letter; Federated Comment Letter (supporting the ICI's comments).

62 ICI Comment Letter; Vanguard Comment Letter; T. Rowe Price Comment Letter; Federated Comment Letter (supporting the ICI's comments). Two commenters noted that the Financial Industry Regulatory Authority (''FINRA'') permits funds to use different approaches to portray the credit quality of split-rated bonds in marketing materials (noting further that funds receive credit rating information through data feeds and that it would be more cost efficient for funds to rely on a single data feed to comply with one consistent SEC/FINRA requirement). *See* ICI Comment Letter; Vanguard Comment Letter.

63 *See* ICI Comment Letter; Federated Comment Letter (supporting the ICI's comments); Vanguard Comment Letter.

64 *See infra* note 70 and accompanying and following text (discussing the difference between using median and average credit ratings).

65 *See* Amended Item 27(d)(2) of Form N–1A; Amended Instruction 6(a) to Item 24 of Form N–2; Amended Instruction 6(i) to Item 28(a) of Form N–3.

66 *See, e.g.,* Fact Sheet, BlackRock Bond Index Fund (portraying credit quality using the median credit rating from among S&P, Moody's, and Fitch, when all three agencies rate a security), available at *https://www2.blackrock.com/webcore/litService/search/getDocument.seam?venue=PUB_IND&source=CONTENT&serviceName=publicServiceView&ContentID=1111147239&venue=FP_ML;* Fact Sheet, Vanguard High-Yield Tax-Exempt Fund Investor Shares (same), available at *https://personal.vanguard.com/us/funds/snapshot?FundId=0044&FundIntExt=INT.*

67 *See supra* note 65; *see also* ICI Comment Letter (recommending that funds be permitted to choose which NRSRO rating to use for split-rated securities, provided that the choice is made pursuant to a disclosed policy).

68 If a fund does not use credit ratings, its description of how the credit quality of the holdings was determined would also need to be near, or as part of, the graphical representation. *See* Amended Item 27(d)(2) of Form N–1A; Amended Instruction 6(a) to Item 24 of Form N–2; Amended Instruction 6(i) to Item 28(a) of Form N–3.

69 For example, Morningstar prefers that bonds be classified using the Barclays Capital Family of Indices ratings rules (*i.e.,* use the middle rating of Moody's, S&P and Fitch after dropping the highest and lowest available ratings; if only two rating agencies rate a security then the lowest rating should be used; and if only one agency rates a security then that rating should be used). *See* Morningstar Fixed-Income Style Box Methodology (Apr. 30, 2012) at *http://corporate.morningstar.com/us/documents/MethodologyDocuments/MethodologyPapers/FixedIncomeStyleBoxMeth.pdf.*

single rating agency (*e.g.,* has the fund selected a designated alternate rating agency); (iv) how the fund reports credit ratings for any security that is not rated by any credit rating agency (*i.e.,* the process for self-rating); or (v) other fund policies on selecting credit ratings for purposes of disclosure. We expect that this discussion, modified and expanded upon by funds as appropriate, will provide investors with insight into how the fund identified and selected the credit ratings used in depicting the fund's portfolio by credit quality.

We recognize that under the final form amendments, a fund has a variety of options when depicting its portfolio holdings using credit quality. For example, a fund might choose not to use credit ratings and could rely instead on internal credit assessments. If a fund does not use credit ratings, we note that it might be misleading for a fund to describe its portfolio holdings quality with similar descriptions as the ratings nomenclature used by rating agencies (*e.g.,* AAA, Aa), or to characterize the securities as ''rated.'' If a fund chooses to depict its portfolio using credit ratings issued by a credit rating agency, a fund could choose to use the *median* credit rating from among multiple credit rating agencies (discarding the highest and lowest ratings) when a security is split-rated.[70] We note, however, that it might be misleading for a fund to disclose an *average* credit quality rating that is based on ratings from multiple credit rating agencies because credit rating agencies may use different criteria to evaluate the credit quality of an issuer. A fund might also choose other methods for evaluating credit quality of portfolio securities, such as a policy of selecting the highest or lowest credit rating for split-rated securities among the ratings issued by certain specified rating agencies.[71] As discussed above, a fund must include in its disclosure a description of how the credit quality of the holdings was determined, no matter the method used.

The amended forms are intended to provide funds with the flexibility to present credit ratings in a manner that more clearly explains the credit quality of the fund's portfolio and the method by which the fund determined that quality.

IV. Paperwork Reduction Act

Certain provisions of the amendments we are adopting contain ''collections of information'' within the meaning of the Paperwork Reduction Act of 1995 (''PRA'').[72] The titles for the existing collections of information we are amending are: (i) ''Rule 30e–1 under the Investment Company Act of 1940, Reports to Stockholders of Management Companies'';[73] and (ii) ''Rule 38a–1 under the Investment Company Act of 1940, Compliance procedures and practices of registered investment companies.'' We adopted those rules pursuant to the Investment Company Act. There is currently no approved collection of information for rule 5b–3, and the amendments do not create any new collections under that rule. The amendments to rule 5b–3 do, however, affect the collection of information burden for rule 38a–1.

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. We published notice soliciting comments on the collection of information requirements in the 2011 Proposing Release and submitted the proposed collections of information to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11 under the control numbers 3235–0025 (rule 30e–1) and 3235–0586 (rule 38a–1). We received no comments on the PRA estimates contained in the 2011 Proposing Release.

A. Rule 38a–1

Rule 5b–3 under the Investment Company Act allows funds to treat the acquisition of a repurchase agreement as an acquisition of securities collateralizing the repurchase agreement for purposes of sections 5(b)(1) and 12(d)(3) of the Investment Company Act under certain conditions. Rule 5b–3, as amended, requires that the securities collateralizing a repurchase agreement consist of securities that the fund's board of directors, or its delegate, determines are issued (or have unconditional guarantees that are issued) by an issuer that has an exceptionally strong capacity to meet its financial obligations and are highly liquid.[74] To that end, the fund's board of directors, pursuant to rule 38a–1 under the Investment Company Act, must have procedures that are reasonably designed to ensure that the fund is able to comply with the conditions of amended rule 5b–3, including the credit quality and liquidity requirements outlined in the amended rule.[75] As discussed above, these procedures should be designed to limit collateral securities to those that are likely to retain a stable market value and that, in ordinary circumstances, the fund would be able to liquidate quickly in the event of a default. This rule 38a–1 collection of information will be mandatory for funds that rely on rule 5b–3. Records of information made in connection with this requirement will be required to be maintained for inspection by Commission staff, but the collection will not otherwise be submitted to the Commission. To the extent that the Commission receives confidential information pursuant to this collection of information, such information would be kept confidential, subject to the provisions of applicable law.[76]

We do not anticipate that the amendments to rule 5b–3 will significantly change collection of information burdens under rule 38a–1 because we believe funds would likely rely significantly on their current policies and procedures to determine the credit quality of collateral securities and comply with amended rule 5b–3. As we indicated above, we understand that credit quality standards for securities collateralizing repurchase agreements typically are contained in the repurchase agreements between funds and counterparties.[77] We understand that those standards currently include a rating (for rated collateral securities) and any additional criteria a fund manager considers

[70] *Id.; see also supra* note 66.

[71] *See, e.g.,* Fact Sheet, Fidelity Institutional Money Market Prime Money Market Portfolio—Institutional CL (categorizing portfolio credit quality for investment grade taxable and municipal bond funds and multi-asset class funds with a fixed income component using the highest credit rating among Moody's, S&P, or Fitch), available at *https://fundresearch.fidelity.com/mutual-funds/composition/31607A208.*

[72] 44 U.S.C. 3501–3520.

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

[74] Amended rule 5b–3(c)(1)(iv)(C). *See supra* section III.A.

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

[76] *See, e.g.,* 5 U.S.C. 552. Exemption 4 of the Freedom of Information Act provides an exemption for ''trade secrets and commercial or financial information obtained from a person and privileged or confidential.'' 5 U.S.C. 552(b)(4). Exemption 8 of the Freedom of Information Act provides an exemption for matters that are ''contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions.'' 5 U.S.C. 552(b)(8).

[77] *See supra* note 53 and accompanying text.

necessary to ensure that the credit quality of the collateral securities meets the fund's requirements, or, for unrated securities, a comparable credit quality standard. Counterparties provide collateral securities to conform to these standards and funds confirm that the securities are conforming. As we have noted above, funds can continue to consider evaluations of outside sources, including credit ratings that the board determines are credible and reliable in making their credit quality determinations under the amended rule. We expect that funds will likely continue to rely on their current policies and procedures (*i.e.,* using credit quality standards that include ratings currently set forth in their repurchase agreements with counterparties). Thus, we do not expect that the amendments to rule 5b–3 will significantly change the current collection of information burden estimates for rule 38a–1.[78] Nevertheless, funds may review their repurchase agreements and policies and procedures that address rule 5b–3 compliance and make technical changes to those documents in response to the amendments. Staff estimated in the proposal and continues to believe that it will take, on average, 1.5 hours of a senior business analyst's time to perform this review and make any technical changes for an individual fund portfolio, for an estimated one-time additional burden of 15,176 hours for all fund portfolios (other than money market fund portfolios).[79] Amortized over three years, the staff estimates that the estimated annual aggregate burden will be 5,059 burden hours.[80]

We anticipate that the fund's board will review the fund manager's recommendation, but that the cost of this review will be incorporated in the fund's overall annual board costs and would not result in any particular additional cost. We received no comments on these estimates and therefore have not modified them.[81]

B. Rule 30e–1

The amendments to Forms N–1A, N–2, and N–3 eliminate the required use of NRSRO credit ratings by funds that choose to use credit quality categorizations in the table, chart, or graph of portfolio holdings provided in shareholder reports. The collection of information is mandatory for those funds that choose to use credit quality categorizations in these forms. If a fund chooses to depict portfolio holdings according to credit quality, the fund must include a description of how the credit quality of the holdings was determined. If credit ratings assigned by a credit rating agency are used, the fund must disclose how it identified and selected the credit ratings. Responses to the disclosure requirements will not be kept confidential.

Although funds would remain obligated to provide a table, chart, or graph of portfolio holdings by reasonably identifiable categories, the amendments require that certain funds must make new disclosures. Under our proposed amendment, we estimated that there would be no additional collection of information burden as a result of proposing to remove the required use of credit ratings from the forms.[82] Under our amended rule, however, funds that choose to use credit quality categorizations must disclose how the fund made the credit quality determinations, and if the fund uses credit ratings issued by a credit rating agency, the fund must disclose how it identified and selected the credit ratings.[83]

Accordingly, based on staff experience, the staff estimates that it will take, on average, 3 hours of an attorney's time to perform this review and make any technical changes to an individual fund's disclosures, for an estimated burden of 32,049 hours for all funds.[84] Amortized over three years, the staff estimates that the estimated annual aggregate burden will be 10,683 burden hours and that there will be approximately 10,683 respondents.[85]

V. Economic Analysis

A. Overview

As discussed above, we are adopting rule and form amendments to implement section 939A of the Dodd-Frank Act. The amendments to rule 5b–3 replace a NRSRO credit rating standard with alternative credit quality and liquidity criteria that are designed to achieve the same purposes as the NRSRO credit rating standard without imposing unnecessarily burdensome costs. The amendments to Forms N–1A, N–2, and N–3 remove the required use of credit ratings when portraying credit quality in shareholder reports, but require that those funds include a description of how the credit quality of the holdings were determined, and if credit ratings assigned by a credit rating agency are used, how the credit ratings were identified and selected. The regulatory changes adopted today will directly affect investment companies registered under the Investment Company Act and could affect the demand for rating agencies' services by eliminating the required use of NRSRO credit ratings in rule 5b–3 and Forms N–1A, N–2, and N–3. The amendments to

[78] The current approved annual burden for rule 38a–1 under the PRA is 248,455 hours. As discussed below, as amended, the collection of information requirement will be 263,631 hours (248,455 + 15,176).

[79] For purposes of this PRA analysis, we assume that all funds enter into repurchase agreements and rely on rule 5b–3. We have not included money market funds in our estimates, however, because they are subject to different requirements for the collateralization of repurchase agreements under rule 2a–7. *See* text accompanying note 34. The staff's estimate is based on staff examination of industry data as of August 31, 2013 and includes 10,117 fund portfolios. We therefore estimate that there will be 10,117 respondents to this collection of information. The amount is calculated as follows: 10,117 fund portfolios × 1.5 hours = 15,176 one-time additional burden hours for all fund portfolios. We estimate that the one-time additional annual burden is 1.5 hours per respondent.

The monetized burden hours are calculated as follows: 15,176 hours × $245 per hour = $3,718,120 one-time additional costs. The staff estimates that the internal cost for time spent by a senior business analyst is $245 per hour. This estimate, as well as other internal time cost estimates made in this analysis, is derived from SIFMA's Management and Professional Earnings in the Securities Industry 2012, modified by Commission staff to account for an 1800-hour work week and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

[80] The amount is calculated as follows: 15,176 burden hours/3 = 5,059 burden hours. Amortized over three years, staff estimates that the annual aggregate burden cost will be: $3,718,820/3 = $1,239,373.

[81] The PRA costs have been modified slightly since the 2011 Proposing Release to reflect a more current estimate of the number of fund portfolios affected, as well as updated hourly wages based on the 2012 SIFMA table.

[82] *See* 2011 Proposing Release, section IV.C.

[83] The current approved annual burden for rule 30e–1 under the PRA is 903,000 hours. As discussed below, as amended, the collection of information requirement will be 935,049 hours (903,000 + 32,049).

[84] The staff's estimate of the number of funds is based on staff examination of industry data as of August 31, 2013 and includes 10,683 funds that collectively file reports on Forms N–1A, N–2, and N–3 each year. We note that this estimate is conservative because it is likely that some fund complexes will achieve economies of scale when revising their disclosures, do not use credit quality when describing portfolio holdings, or whose current disclosures already satisfy the requirements of the amended rule and thus would not need to make any changes. The amount is calculated as follows: 10,683 funds × 3 hours = 32,049 one-time additional burden hours for all funds. We estimate that the one-time additional annual burden is 3 hours per respondent.

The monetized burden hours are calculated as follows: 32,049 hours × $379 per hour = $12,146,571 one-time additional costs. The staff estimates that the internal cost for time spent by an in-house attorney is $379 per hour. This estimate, as well as other internal time cost estimates made in this analysis, is derived from SIFMA's Management and Professional Earnings in the Securities Industry 2012, modified by Commission staff to account for an 1800-hour work week and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

[85] The amount is calculated as follows: 32,049 burden hours/3 = 10,683 burden hours. Amortized over three years, staff estimates that the annual aggregate burden cost will be: $12,146,571/3 = $4,048,857.

rule 5b–3 may also affect other parties such as repurchase agreement counterparties (*e.g.,* broker-dealers and banks), investors, and issuers of collateral securities. Finally, we recognize that the elimination of the required use of NRSRO credit ratings in rule 5b–3 and Forms N–1A, N–2, and N–3 may reduce the incentive for credit rating agencies to register as NRSROs and thereby be subject to the Commission's oversight and statutory and regulatory requirements applicable to NRSROs. We received no comments on the cost-benefit analysis contained the 2011 Proposing Release.

At the outset, the Commission notes that, where possible, we have attempted to quantify the costs and benefits expected to result from adopting the amendments to rule 5b–3 and Forms N–1A, N–2, and N–3. However, wherever the discussion of costs or benefits is not quantified in this section it is because the Commission is unable to quantify the economic effects because it lacks the information necessary to provide a reasonable estimate. For example, as discussed below, the Commission does not have available to it comprehensive information on the exposure of funds to different repurchase agreement market segments, the nature and type of collateral used in repurchase agreements, or the extent to which funds rely on rule 5b–3. Because of this lack of data, including the extent to which funds may rely on rule 5b–3, we are unable to quantify the costs to comply with the amended rule and note that the costs could vary from our estimates. We discuss below the economic baseline, costs and benefits of our final rule and form amendments, alternatives considered, as well as the impact on efficiency, competition, and capital formation.

B. Rule 5b–3

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

1. Economic Baseline

The economic baseline against which we measure the economic effects of these amendments is the regulatory framework as it exists immediately before the adoption of today's amendments. Currently, rule 5b–3 allows funds to treat the acquisition of a repurchase agreement as an acquisition of securities collateralizing the repurchase agreement for certain diversification and broker-dealer counterparty limit purposes under the Investment Company Act if the obligation of the seller to repurchase the securities from the fund is "collateralized fully." In general, under rule 5b–3, a fund investing in a repurchase agreement looks to the value and liquidity of the securities collateralizing the repurchase agreement rather than the creditworthiness of the counterparty for satisfaction of the repurchase agreement. Under current requirements, a repurchase agreement is collateralized fully if, among other things, the collateral for the repurchase agreement consists entirely of (i) cash items, (ii) government securities, (iii) securities that at the time the repurchase agreement is entered into are rated in the highest rating category by the "Requisite NRSROs" or (iv) unrated securities that are of a comparable quality to securities that are rated in the highest rating category by the Requisite NRSROs, as determined by the fund's board of directors or its delegate.

As of the end of 2012, the total repurchase agreement market approximated $3 trillion.[86] The repurchase agreement market has two primary segments, bilateral and tri-party.[87] The bilateral segment comprises cash-driven transactions against specific collateral while the tri-party segment comprises cash-driven transactions against general collateral. We believe that investment companies' primary exposure to repurchase agreements is through the tri-party market, but the Commission does not have available to it comprehensive information on the exposure in either market segment. The collateral used in the approximately $2 trillion tri-party market is dominated by government securities: Approximately 35% consists of Treasury securities and approximately 50% consists of agency mortgage-backed securities, agency debentures, and agency collateralized mortgage obligations.[88]

While we believe that many funds invest in tri-party repurchase agreements, comprehensive information about the extent to which funds invest in these agreements is not available to us. Nor are we able to estimate how often funds rely on rule 5b–3 when entering into repurchase agreements, or the extent to which fund repurchase agreements are collateralized with securities other than cash or government securities. However, we are able to estimate the extent of money market fund participation in the tri-party repurchase market using Form N–MFP data, which shows that money market funds held approximately $591 billion in tri-party repurchase agreements as of the end of 2012. While we understand almost all funds rely on rule 5b–3 on occasion (for example when approaching diversification limits or avoiding restrictions on investments in certain entities), we do not have the information necessary to determine how frequently those funds rely on rule 5b–3 in their daily transactions in repurchase agreements. Accordingly, we are largely unable to quantify the benefits and costs discussed below.

2. Economic Analysis

Amended rule 5b–3 is intended to establish a similar credit quality standard to the NRSRO credit rating standard we are replacing in order to achieve the same objectives that the NRSRO credit rating reference requirement was designed to achieve in the existing rule, *i.e.,* limit collateral securities to those that are likely to retain a stable market value and that, under ordinary circumstances, the fund would be able to liquidate quickly at or near its carrying value in the event of a counterparty default. Although amended rule 5b–3 seeks to maintain a similar degree of credit quality as the standard it replaces, the Dodd-Frank Act mandate is designed to reduce reliance on NRSRO credit ratings.[89]

Some fund boards or their delegates, after independent analysis, might make a determination of credit quality that comports with the analysis of the NRSRO credit ratings and, accordingly, make no substantive changes to the funds' investments in repurchase agreements. Other fund boards might turn to non-NRSRO sources ("third-party providers") to satisfy the new requirements, which may result in a different pool of assets from which the funds may select for collateralizing

[86] *See* Financial Stability Oversight Council, 2013 Annual Report at 65–66, available at *http://www.treasury.gov/initiatives/fsoc/Documents/FSOC%202013%20Annual%20Report.pdf.*

[87] *See id.* (noting a third repo market segment—the general collateral finance market—which primarily settles inter-dealer transactions on the tri-party repo platform).

[88] *Id.*

[89] *See supra* note 12.

repurchase agreements. We believe that this flexibility of allowing for a broader range of credit quality models will increase competition for such models, whether from internal assessments made by the fund or from external assessments made by third-party providers such as credit rating agencies. As a result, credit assessments, and the repurchase agreement market in general, may become more efficient and may promote capital formation through a more accurate assessment of credit risk that may increase investment in repurchase agreements.

We recognize, as discussed above, that funds typically establish standards for the credit quality of collateral securities (that include credit ratings and additional credit quality criteria required by the fund) in repurchase agreements with counterparties.[90] Funds could change their policies and procedures to reflect changes made to the rule by the amendments, but the rule would not prohibit funds from considering the standards in current repurchase agreements and policies and procedures provided that the fund's board or its delegate made the determination that those standards satisfy the standards in amended rule 5b–3. As a result, amended rule 5b–3 may not significantly change the types of collateral securities held by funds relying on rule 5b–3.

Amended rule 5b–3 requires the fund's board or its delegate to make a determination about the collateral of each repurchase agreement. This will increase the regulatory burden on the fund's board,[91] but we believe that the burden is significantly reduced by the fund board's ability to incorporate ratings, reports, analyses, and other assessments issued by third parties, including NRSRO ratings that the fund's board concludes are credible and reliable for purposes of making the evaluation. Moreover, fund boards that find these increased regulatory burdens to be excessive can mitigate them by restricting the fund to repurchase agreement collateral that consists of cash and government securities.

If the fund's board decides to rely primarily on NRSRO ratings as part of the process of evaluating credit quality, the fund may incur some additional costs from today's amendments.[92] However, some fund boards may decide not to rely primarily on NRSRO ratings, perhaps because of a more cost efficient way of making the required determinations or because they believe NRSRO ratings are not helpful or sufficient in evaluating credit quality. Reducing the emphasis on NRSRO ratings could also adversely affect the quality of NRSRO ratings. Currently, the importance attached to NRSRO ratings may impart franchise value to the NRSRO's ratings business. By eliminating references to NRSRO ratings in Federal regulations, section 939A of the Dodd-Frank Act could reduce these franchise values and mitigate NRSROs' incentives to produce credible and reliable ratings. Moreover, the Commission recognizes that the elimination of the required use of credit ratings in Commission rules and forms may reduce the incentive for credit rating agencies to register as NRSROs with the Commission and thereby be subject to the Commission's oversight and the statutory and regulatory requirements applicable to NRSROs. To the extent that the quality and accuracy of NRSRO ratings is adversely affected, negative impacts on the capital allocation process and economic efficiency would result.

The new methodologies that the fund's board employs may result in a pool of assets from which the fund may select for collateralizing repurchase agreements that is different from a pool based on NRSRO ratings. This may affect the fund relative to the baseline of NRSRO ratings by including or excluding as collateral assets that are different from the collateral permitted under the current rule. In turn, this could increase the credit risk in the pool of collateral assets or decrease the return earned by investing in repurchase agreements. Both of these effects may lead to a less efficient market for repurchase agreement collateral. Issuers' ability to raise capital may also be adversely affected to the extent that issuers of collateral securities lose the regulatory preference that currently exists because of the required use of NRSRO ratings within rule 5b–3. We do not, however, believe that the amended rule is likely to lead to the acceptance of riskier collateral in practice because the standard we are adopting is very similar to the standard articulated by the NRSROs for securities that have received the highest ratings. In addition, we anticipate that fund boards and advisers will retain the credit quality standards in their current repurchase agreements and their existing policies and procedures that address compliance with current rule 5b–3 and include ratings that they believe are credible and reliable.

Although we believe that boards of funds relying on rule 5b–3 have established policies and procedures for complying with the rule,[93] funds may incur costs to revise existing policies and procedures for investing in repurchase agreements to comply with amended rule 5b–3. We recognize that increased compliance costs are a necessary result of our amendments to rule 5b–3 and may disproportionately impact smaller funds to the extent these funds do not today have policies and procedures for assessing creditworthiness. As noted above, we are not able to quantify many of the costs (and benefits) discussed above. However, we estimate that each fund will incur, at a minimum, the collection of information costs discussed in the Paperwork Reduction Act section for a total average one-time cost of approximately $368 per fund.[94] Funds may also incur additional costs in complying with the amendments which we are unable to quantify, for the reasons discussed above.

3. Alternatives

In adopting today's amendments to rule 5b–3, the Commission considered, as noted by one commenter, including specific factors or tests that a fund board must apply in performing its credit analysis under the rule.[95] As noted above, the number and scope of factors that may be appropriate to making a credit quality determination with respect to a security may vary significantly depending on the particular security and through time. Accordingly, we are not adopting specific factors or tests that a fund board must apply in performing credit analysis, but may provide guidance in the future.[96]

We also considered different standards to replace credit ratings that would help ensure that funds can liquidate collateral quickly in the event of a default. These alternatives included, for example, omitting an explicit liquidity requirement because securities in the ''highest rating category'' generally are more liquid than lower quality securities. Other liquidity alternatives we considered included limiting collateral securities only to cash and government securities because liquidity may decline between the time of acquisition and the time of default, or prohibiting a fund from relying on rule

[90] *See supra* text preceding note 53.

[91] *See* NY City Bar Comment Letter, *supra* note 44.

[92] *See supra* text following note 53.

[93] *See* rule 38a–1(a).

[94] *See supra* note 79 and accompanying text. Staff estimates that all funds will incur a one-time aggregate cost of approximately $3.7 million to make any necessary changes related to collections of information under the Paperwork Reduction Act. *Id.*

[95] *See supra* note 43.

[96] *See supra* notes 43–46 and accompanying text.

5b–3 if, at any point after the time a fund enters into a repurchase agreement, the collateral could no longer be liquidated within seven calendar days. After considering the alternatives, we believe that amended rule 5b–3 strikes a better balance than the alternatives by imposing a liquidity requirement that is similar to the liquidity standard inherent to the credit quality rating required under the current rule, while not unduly restricting funds' flexibility to utilize a larger pool of assets for collateralizing repurchase agreements.

C. Forms N–1A, N–2, and N–3

Forms N–1A, N–2, and N–3, as amended, eliminate the required use of NRSRO credit ratings by funds that choose to use credit quality categorizations in the required table, chart, or graph of portfolio holdings. If a fund chooses to depict portfolio holdings according to credit quality, the fund must include a description of how the credit quality of the holdings was determined. If a fund uses credit ratings assigned by a credit rating agency to depict credit quality, the fund must disclose how it identified and selected the credit ratings.

1. Economic Baseline

As noted above, the economic baseline against which we measure the economic effects is the regulatory framework as it exists immediately before the adoption of today's amendments. Currently, Forms N–1A, N–2, and N–3 require shareholder reports to include a table, chart, or graph depicting portfolio holdings by reasonably identifiable categories (*e.g.,* type of security, industry sector, geographic region, credit quality, or maturity). The forms require the categories to be selected in a manner reasonably designed to depict clearly the types of investments made by the fund, given its investment objectives. If credit quality is used to present portfolio holdings, the forms currently require that credit quality be depicted using the credit ratings assigned by a single NRSRO.

We believe, based on staff experience, that the majority of funds choose to depict their portfolios using credit quality, and accordingly, report credit ratings from a single NRSRO. As discussed above, we conservatively estimate that 10,683 funds collectively file reports on Forms N–1A, N–2, and N–3 each year and will be affected by the amendments.[97]

2. Economic Analysis

The Dodd-Frank Act mandate is designed to reduce potential reliance on NRSRO credit ratings. Under the amendments, funds have greater flexibility to assess and depict credit quality, which may lead to better-informed investors who can, in turn, make better capital allocation decisions. Accordingly, better-informed investors may make more effective investment decisions based on their risk tolerance and may promote increased competition among funds. We note, however, that funds might choose to report credit quality in a more positive light than is possible under the prior requirement to use the credit ratings from a single NRSRO. However, as discussed above, the disclosure requirements we are adopting today should mitigate many of the potential adverse consequences. As a result, today's amendments may have a varied effect on investors' ability to make effective capital allocation choices.

Because we do not anticipate that these amendments will result in large changes in the portfolios held by funds or their investors, we do not believe the amendments would have more than a marginal effect on efficiency or capital formation. A potential benefit may arise by allowing funds to use different credit rating agencies for split-rated securities because that may promote competition between credit rating agencies to provide ratings that are more accurate if funds use the most accurate ratings for each part of their portfolios even if those ratings come from different credit rating agencies. This may foster innovation in the industry, and it may foster the growth of niche credit rating agencies. Although some funds may eliminate the specific use of credit ratings in their depiction of portfolio credit quality, we anticipate that many of those funds are likely to consider some outside analyses in evaluating the credit quality of portfolio securities.[98] A fund's consideration of external analyses by third-party sources determined to be credible and reliable may contribute to the accuracy of funds' determinations and thus help funds arrive at consistent and more accurate depictions of credit quality.

Under the amended forms, funds may continue to depict portfolio holdings as they do today: Funds can continue to depict portfolio holdings without making reference to credit quality, and funds can continue to depict portfolio holdings using credit ratings from one NRSRO. Today's amendments impose no new costs on funds that depict portfolio holdings based on criteria other than credit quality, but they do impose small additional costs on funds that choose to portray portfolio holdings using credit ratings from one NRSRO because they must make new disclosures about how the ratings were identified and selected. We believe that the majority of costs related to today's amendments to Forms N–1A, N–2, and N–3 are the costs described above related to the collections of information under the Paperwork Reduction Act. Accordingly, we estimate that funds on average will incur costs of approximately $1,137 per fund in complying with the amendments.[99] In addition, funds may voluntarily incur additional costs if they choose to develop and apply new methodologies to depict credit quality. Funds that choose to do so will incur a cost not only to determine the credit quality of portfolio holdings but also a cost to include in the registration statement a description of how the credit quality of portfolio holdings was determined, and if credit ratings are used, how the ratings were identified and selected.

3. Alternatives

In adopting the amendments to the forms, the Commission considered replacing the required use of credit ratings with an option to depict a fund's portfolio by credit quality using the credit ratings of only a single credit rating agency. This approach, proposed in 2011, was intended to eliminate the possibility that a fund could choose to use NRSRO credit ratings and then select the most favorable ratings among the credit ratings assigned by multiple NRSROs. As discussed above, a number of commenters suggested that funds be permitted to use the credit ratings assigned by more than one NRSRO for split-rated securities, provided the choice is made consistently, pursuant to a disclosed policy. On balance, we believe that the benefits of this additional flexibility outweigh the potential costs associated with the possibility that funds cherry pick the highest credit rating available. We note that the risks associated with cherry picking ratings are mitigated by the fact that the forms, as amended, require that

[97] *See supra* note 84.

[98] Funds may elect to use a combination of factors, including NRSRO credit ratings, in depicting credit quality; or funds may use or establish entirely new methods of depicting credit quality. *See* ICI Comment Letter; Federated Comment Letter (supporting the ICI Comment Letter).

[99] *See supra* note 84 and accompanying text. Staff estimates that all funds will incur a one-time aggregate cost of approximately $12.1 million to make any necessary changes to the registration statement related to collections of information under the Paperwork Reduction Act. *Id.*

funds disclose how they identified and selected the credit ratings, which would include, for example, a fund policy that selects the highest credit rating available.

VI. Final Regulatory Flexibility Analysis

The Commission has prepared the following Final Regulatory Flexibility Analysis (''FRFA'') in accordance with section 4(a) of the Regulatory Flexibility Act regarding the rule and form amendments we are adopting today to give effect to provisions of the Dodd-Frank Act.[100] The FRFA relates to amendments to rule 5b–3 under the Investment Company Act and Forms N–1A, N–2, and N–3 under the Investment Company Act and Securities Act. We prepared an Initial Regulatory Flexibility Analysis (''IRFA'') in conjunction with the 2011 Proposing Release in March 2011.[101]

A. Need for and Objectives of the Rule and Form Amendments

As described more fully in sections I and III of this Release, to implement section 939A of the Dodd-Frank Act, the Commission is adopting amendments to (i) rule 5b–3 to eliminate references to the credit rating and replace it with an alternative standard of creditworthiness that is intended to achieve the same objectives that the credit rating requirement was designed to achieve and (ii) Forms N–1A, N–2, and N–3 to eliminate the required use of NRSRO credit ratings by funds that choose to use credit quality categorizations in the required table, chart, or graph of portfolio holdings in their shareholder reports, and to permit funds that choose to depict credit quality using credit ratings assigned by a credit rating agency to use different credit rating agencies for split-rated securities.

B. Significant Issues Raised by Public Comment

In the 2011 Proposing Release, we requested comment on the IRFA. In particular, we sought comment on how many small entities would be subject to the proposed rule and form amendments and whether the effect of the proposed rule and form amendments on small entities subject to them would be economically significant. None of the comment letters we received addressed the IRFA. None of the comment letters made comments about the effect of the rule and form amendments on small investment companies.

C. Small Entities Subject to the Rule and Form Amendments

The amendments to rule 5b–3 and Forms N–1A, N–2, and N–3 under the Investment Company Act would affect funds, including entities that are considered to be a small business or small organization (collectively, ''small entity'') for purposes of the Regulatory Flexibility Act.

Investment Companies. Under Commission rules, for purposes of the Investment Company Act and the Regulatory Flexibility Act, an investment company is a small entity if it, together with other investment companies in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year.[102] Based on a current review of filings submitted to the Commission, we estimate that 171 investment companies may be considered small entities and that all of these investment companies may potentially rely on rule 5b–3.[103] As discussed above, we recognize that increased compliance costs are a necessary result of the amendments to rule 5b–3 and may disproportionately impact smaller funds to the extent these funds do not have policies and procedures for assessing creditworthiness. Based on a current review of filings submitted to the Commission, we estimate that approximately 131 investment companies that meet the definition of small entity would be subject to the amendments to Forms N–1A, N–2, and N–3.

D. Projected Reporting, Recordkeeping, and Other Compliance Requirements

Rule 5b–3. The amendments to rule 5b–3 allow a fund to treat the acquisition of a repurchase agreement as an acquisition of securities collateralizing the repurchase agreement for purposes of sections 5(b)(1) and 12(d)(3) of the Investment Company Act if the collateral other than cash or government securities consists of securities that the fund's board of directors (or its delegate) determines at the time the repurchase agreement is entered into are: (i) Issued by an issuer that has an exceptionally strong capacity to meet its financial obligations; and (ii) sufficiently liquid that they can be sold at approximately their carrying value in the ordinary course of business within seven calendar days. A fund that acquires repurchase agreements and intends the acquisition to be treated as an acquisition of the collateral securities must determine whether it must change its policies for evaluating collateral securities under the amended rule and must adopt and implement written policies and procedures reasonably designed to comply with the conditions of amended rule 5b–3, including these credit quality and liquidity requirements that we are adopting.[104] The costs associated with the amendments to rule 5b–3 are those discussed in section IV.A and V.B above.

Forms N–1A, N–2, and N–3. The amendments to Forms N–1A, N–2, and N–3 apply to open-end management investment companies, closed-end management investment companies, and separate accounts organized as management investment companies that offer variable annuity contracts, including those that are small entities. The amendments to Forms N–1A, N–2, and N–3 eliminate the required use of NRSRO credit ratings by funds that choose to use credit quality categorizations in the required table, chart, or graph of portfolio holdings in their shareholder reports. If a fund chooses to depict portfolio holdings according to credit quality, it must include a description of how the credit quality of the holdings was determined, and if credit ratings assigned by a credit rating agency are used to depict credit quality, the fund must disclose how it identified and selected the credit ratings. The amended forms also permit funds that choose to depict credit quality using credit ratings assigned by a credit rating agency to use different credit rating agencies for split-rated securities. The costs associated with the amendments to the forms are those discussed in section IV.B and V.C above.

E. Agency Action To Minimize Effect on Small Entities

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish our stated objectives, while minimizing any significant adverse effect on small entities. In connection with the rule and form amendments, the Commission considered the following alternatives: (i) Establishing different compliance standards or timetables that take into account the resources available to small

[100] 5 U.S.C. 604(a).

[101] *See* 2011 Proposing Release, *supra* note 10, at section VIII.

[102] 17 CFR 270.0–10(a).

[103] The 183 investment companies that meet the definition of small entity include 12 business development companies, which are subject to sections 5 and 12 of the Investment Company Act. 15 U.S.C. 80a–58; 15 U.S.C. 80a–59.

[104] 17 CFR 270.38a–1(a).

entities; (ii) clarifying, consolidating, or simplifying compliance and reporting requirements under the rule for small entities; (iii) use of performance rather than design standards; and (iv) exempting small entities from all or part of the requirements.

We believe that special compliance or reporting requirements for small entities, or an exemption from coverage for small entities, is not appropriate or consistent with investor protection or the Dodd-Frank Act. We believe that, with respect to rule 5b–3, different credit quality standards, special compliance requirements or timetables for small entities, or an exemption from coverage for small entities, may create a risk that those entities could acquire repurchase agreements with collateral that is less likely to retain its market value or liquidity in the event of a counterparty default. Further consolidation or simplification of the rule and form amendments for funds that are small entities is inconsistent with the Commission's goals of fostering investor protection.

The form amendments apply to all investment companies that use Forms N–1A, N–2, and N–3 to register under the Investment Company Act and to offer their securities under the Securities Act. If the Commission had excluded small entities from the form amendments, small entities would have been required to use NRSRO credit ratings if they chose to depict credit quality, while other entities would not have been subject to that requirement. We believe that special compliance or reporting requirements, or an exemption, for small entities would not be appropriate because the amended requirement—eliminating the required use of credit ratings where a fund chooses to depict the fund's portfolio based on credit quality—is intended to eliminate potential reliance on NRSRO credit ratings resulting from the perception that the Commission endorses the ratings because of their required use in Commission forms.

We have endeavored through the form amendments to minimize regulatory burdens on investment companies, including small entities, while meeting our regulatory objectives. We have endeavored to clarify, consolidate, and simplify the requirements applicable to investment companies, including those that are small entities. Finally, the amendments will use performance rather than design standards for determining the credit quality of specific securities. For these reasons, we have not adopted alternatives to rule 5b–3 and Forms N–1A, N–2, and N–3.

Statutory Authority

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

List of Subjects

17 CFR Part 239

Reporting and recordkeeping requirements, Securities.

17 CFR Parts 270 and 274

Investment companies, Reporting and recordkeeping requirements, Securities.

Text of Rule and Rule and Form Amendments

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

PART 239—FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

■ 1. The authority citation for Part 239 is revised to read in part as follow:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z–2, 77z–3, 77sss, 78c, 78*l,* 78m, 78n, 78*o*(d), 78o–7, 78o–7 note, 78u–5, 78w(a), 78*ll,* 78mm, 80a–2(a), 80a–3, 80a–8, 80a–9, 80a–10, 80a–13, 80a–24, 80a–26, 80a–29, 80a–30, 80a–37, and Pub. L. 111–203, sec. 939A, 124 Stat. 1376 (2010), unless otherwise noted.

* * * * *

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

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

Authority: 15 U.S.C. 80a–1 *et seq.,* 80a–34(d), 80a–37, 80a–39, and Pub. L. 111–203, sec. 939A, 124 Stat. 1376 (2010), unless otherwise noted.

* * * * *

■ 3. Section 270.5b–3 is amended by:
■ a. Adding ''or'' at the end of paragraph (c)(1)(iv)(B);
■ b. Revising paragraph (c)(1)(iv)(C);
■ c. Removing paragraph (c)(1)(iv)(D);
■ d. Removing paragraphs (c)(5), (c)(6), and (c)(8);
■ e. Redesignating paragraph (c)(4) as (c)(5);
■ f. Adding new paragraph (c)(4); and
■ g. Redesignating paragraph (c)(7) as paragraph (c)(6).

The revisions and addition read as follows:

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

* * * * *

(c) * * *
(1) * * *
(iv) * * *
(C) Securities that the investment company's board of directors, or its delegate, determines at the time the repurchase agreement is entered into:

(1) Each issuer of which has an exceptionally strong capacity to meet its financial obligations; and

Note to paragraph (c)(1)(iv)(C)(*1*): For a discussion of the phrase ''exceptionally strong capacity to meet its financial obligations'' see Investment Company Act Release No. 30847, (December 27, 2013).

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

* * * * *

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

* * * * *

PART 239—FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

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

■ 4. The authority citation for Part 274 is revised to read in part as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78l, 78m, 78n, 78o(d), 80a–8, 80a–24, 80a–26, 80a–29, and Pub. L. 111–203, sec. 939A, 124 Stat. 1376 (2010), unless otherwise noted.

* * * * *

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

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

FORM N–1A

* * * * *

Item 27. Financial Statements

* * * * *

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

(2) *Graphical Representation of Holdings.* One or more tables, charts, or graphs depicting the portfolio holdings of the Fund by reasonably identifiable categories (*e.g.,* type of security, industry sector, geographic region, credit quality, or maturity) showing the percentage of net asset value or total investments attributable to each. The categories and the basis of presentation (*e.g.,* net asset value or total investments) should be selected, and the presentation should be formatted, in a manner reasonably designed to depict clearly the types of investments made by the Fund, given its investment objectives. If the Fund depicts portfolio holdings according to credit quality, it should include a description of how the credit quality of the holdings were determined, and if credit ratings, as defined in section 3(a)(60) of the Securities Exchange Act [15 U.S.C. 78(c)(a)(60)], assigned by a credit rating agency, as defined in section 3(a)(61) of the Securities Exchange Act [15 U.S.C. 78(c)(a)(61)], are used, explain how they were identified and selected. This description should be included near, or as part of, the graphical representation.

* * * * *

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

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

FORM N–2

* * * * *

Item 24. Financial Statements

* * * * *

Instructions:

* * * * *

6. * * *

a. one or more tables, charts, or graphs depicting the portfolio holdings of the Fund by reasonably identifiable categories (*e.g.,* type of security, industry sector, geographic region, credit quality, or maturity) showing the percentage of net asset value or total investments attributable to each. The categories and the basis of presentation (*e.g.,* net asset value or total investments) should be selected, and the presentation should be formatted, in a manner reasonably designed to depict clearly the types of investments made by the Fund, given its investment objectives. If the Fund depicts portfolio holdings according to credit quality, it should include a description of how the credit quality of the holdings were determined, and if credit ratings, as defined in section 3(a)(60) of the Securities Exchange Act [15 U.S.C. 78(c)(a)(60)], assigned by a credit rating agency, as defined in section 3(a)(61) of the Securities Exchange Act [15 U.S.C. 78(c)(a)(61)], are used, explain how they were identified and selected. This description should be included near, or as part of, the graphical representation.

* * * * *

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

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

FORM N–3

* * * * *

Item 28. Financial Statements

(a) * * *

Instructions:

* * * * *

6. * * *

(i) One or more tables, charts, or graphs depicting the portfolio holdings of the Fund by reasonably identifiable categories (*e.g.,* type of security, industry sector, geographic region, credit quality, or maturity) showing the percentage of net asset value or total investments attributable to each. The categories and the basis of presentation (*e.g.,* net asset value or total investments) should be selected, and the presentation should be formatted, in a manner reasonably designed to depict clearly the types of investments made by the Fund, given its investment objectives. If the Fund depicts portfolio holdings according to credit quality, it should include a description of how the credit quality of the holdings were determined, and if credit ratings, as defined in section 3(a)(60) of the Securities Exchange Act [15 U.S.C. 78(c)(a)(60)], assigned by a credit rating agency, as defined in section 3(a)(61) of the Securities Exchange Act [15 U.S.C. 78(c)(a)(61)], are used, explain how they were identified and selected. This description should be included near, or as part of, the graphical representation.

* * * * *

By the Commission.

Dated: December 27, 2013.

Lynn M. Powalski,

Deputy Secretary.

[FR Doc. 2013–31425 Filed 1–7–14; 8:45 am]

BILLING CODE P

DEPARTMENT OF VETERANS AFFAIRS

38 CFR Part 17

RIN 2900–AO62

Community Residential Care

AGENCY: Department of Veterans Affairs.

ACTION: Final rule.

SUMMARY: This rule adopts as final, without change, an interim final rule amending the Department of Veterans Affairs (VA) regulations concerning approval of non-VA community residential care (CRC) facilities to allow VA to waive such facilities' compliance with standards that do not jeopardize the health or safety of residents. As amended, the regulation allows VA to grant a waiver of a CRC standard in those limited circumstances where the deficiency cannot be corrected to meet a standard provided for in VA regulation. This rulemaking also makes a certain necessary technical amendment to correct a reference to the section addressing requests for a hearing.

DATES: *Effective Date:* This final rule is effective January 8, 2014.

FOR FURTHER INFORMATION CONTACT: Nancy Quest, Director, Home and Community Based Services (10P4G), Veterans Health Administration, 810 Vermont Avenue NW., Washington, DC 20420, (202) 461–6064. (This is not a toll-free number.)

SUPPLEMENTARY INFORMATION: In an interim final rule published in the **Federal Register** on May 29, 2013, at 78 FR 32124, VA amended 38 CFR 17.65, which contains VA's regulations governing approvals and provisional approvals of CRC facilities. The interim final rule allowed VA to waive one or more of the standards in 38 CFR 17.63 for the approval of a particular CRC facility, provided that a VA safety expert certifies that the deficiency does not endanger the life or safety of the residents; the deficiency cannot be corrected; and granting the waiver is in the best interests of the veteran in the facility and VA's CRC program. The rulemaking also made a certain necessary technical amendment to § 17.66. The interim final rule was effective immediately upon publication and provided a 60-day comment period, which ended on July 29, 2013. VA received no public comments and therefore makes no changes to the regulation.

Based on the rationale set forth in the interim final rule, VA is adopting the