months or more after issuance of the Commission's regulatory guide giving details and examples of approaches to satisfy these requirements (whichever is later).

(2) If the licensee chooses to install or modify systems, structures, or components to comply with the requirements of paragraph (c) of this section, such hardware installation and/or modification must be completed by the end of the first refueling outage that starts either 12 months or more after the effective date of this section or 12 months or more after issuance of the Commission's regulatory guide giving details and examples of approaches to satisfy these requirements (whichever is later).

(3) All licensees must submit technical specifications required by paragraph (c)(3)(iii) within 6 months after issuance of the final regulatory guide providing guidance on compliance with the requirements of this section.

(4) All licensees of PWRs, except as noted in paragraph (e)(5) of this section, must comply with paragraph (d) of this section by the end of the first refueling outage that starts either 12 months or more after the effective date of this section or 12 months or more after issuance of the Commission regulatory guide giving details and examples of approaches to satisfy this requirement (whichever is later).

(5) The requirement in paragraph (e)(4) of this section does not apply to those plants that have completely defueled for final shutdown but still retain an operating license (i.e., those plants that are preparing for decommissioning).

Dated at Rockville, Maryland, this 14th day of October, 1994.

For the Nuclear Regulatory Commission.

John C. Hoyle,

Acting Secretary of the Commission.

[FR Doc. 94-25916 Filed 10-18-94; 8:45 am]

BILLING CODE 7590-01-P

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 325

RIN 3064-AB43

Capital; Capital Adequacy Guidelines

AGENCY: Federal Deposit Insurance Corporation (FDIC or Corporation).

ACTION: Notice of proposed rulemaking.

SUMMARY: The FDIC is proposing to amend its risk-based capital guidelines for state nonmember banks. The proposal would revise and expand the set of conversion factors used to calculate the potential future exposure of derivative contracts and recognize effects of netting arrangements in the calculation of potential future exposure for derivative contracts subject to qualifying bilateral netting arrangements.

The FDIC is proposing these amendments on the basis of proposed revisions to the Basle Accord announced on July 15, 1994. The effect of the proposed amendments would be twofold. First, long-dated interest rate and exchange rate contracts would be subject to new higher conversion factors and new conversion factors would be set forth that specifically apply to derivative contracts related to equities, precious metals, and other commodities. Second, institutions would be permitted to recognize a reduction in potential future exposure for transactions subject to qualifying bilateral netting arrangements.

DATES: Comments must be received on or before December 5, 1994.

ADDRESSES: Send comments to Robert E. Feldman, Acting Executive Secretary, Federal Deposit Insurance Corporation, 550 17th Street, N.W., Washington, D.C. 20429. Comments may be hand delivered to room F-402, 1776 F Street, N.W., Washington, D.C., on business days between 8:30 a.m. and 5:00 p.m. [Fax number: (202) 898-3838.] Comments may be inspected at the FDIC's Reading Room, room 7118, 550 17th Street, N.W., Washington, D.C. between 9:00 a.m. and 4:30 p.m. on business days.

FOR FURTHER INFORMATION CONTACT: William A. Stark, Assistant Director, (202) 898-6972, Division of Supervision, FDIC; Sharon K. Lee, Chief, Capital Markets Policy and Training, (202) 898-6789, Division of Supervision, FDIC; Jeffrey M. Kopchik, Counsel, (202) 898-3872, Legal Division, FDIC, 550 17th Street, N.W., Washington, D.C. 20429.

SUPPLEMENTARY INFORMATION:

I. Background

The international risk-based capital standards (the Basle Accord or Accord) [1] set forth a framework for measuring capital adequacy under which risk-weighted assets are calculated by assigning assets and off-balance-sheet items to broad categories based primarily on their credit risk, that is, the risk that a loss will be incurred due to an obligor or counterparty default on a transaction.[2] Off-balance-sheet transactions are incorporated into risk-weighted assets by converting each item into a credit equivalent amount which is then assigned to the appropriate credit risk category according to the identity of the obligor or counterparty, or if relevant, the guarantor or the nature of the collateral.

The credit equivalent amount of an interest rate or exchange rate contract (rate contract) is determined by adding together the current replacement cost (current exposure) and an estimate of the possible increases in future replacement cost, in view of the volatility of the current exposure over the remaining life of the contract (potential future exposure, also referred to as the add-on). Each credit equivalent amount is then assigned to the appropriate risk category generally based on identity of the counterparty. The maximum risk weight applied to interest rate or exchange rate contracts is 50 percent.[3]

A. Current Exposure

A state nonmember bank that has a rate contract with a positive mark-to-market value has a current exposure or a possible loss equal to the mark-to-market value.[4] For risk-based capital purposes, if the mark-to-market value is zero or negative, then there is no replacement cost associated with the contract and the current exposure is zero. The sum of current exposures for a defined set of contracts is sometimes referred to as the gross current exposure for that set of contracts.

The Accord, as endorsed in 1988, provided that current exposure would be determined individually for every rate contract entered into by a banking organization. Generally, institutions were not permitted to offset, that is, net,

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[1] The Basle Accord was proposed by the Basle Committee on Banking Supervision (Basle Supervisors' Committee, BSC) and endorsed by the central bank governors of the Group of Ten (G-10) countries in July 1988. The Basle Supervisors' Committee is comprised of representatives of the central banks and supervisory authorities from the G-10 countries (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, the United Kingdom, and the United States) and Luxembourg.

In January 1989 the FDIC Board adopted a similar framework to be used by state nonmember banks.

[2] Other types of risks, such as market risks, generally are not addressed by the risk-based framework.

[3] Exchange rate contracts with an original maturity of 14 calendar days or less and instruments traded on exchanges that require daily payment of variation margin are excluded from the risk-based capital ratio calculations.

[4] The loss to a bank from a counterparty's default on a rate contract is the cost of replacing the cash flows specified by the contract. The mark-to-market value is the present value of the net cash flows specified by the contract, calculated on the basis of current market interest and exchange rates.

positive and negative mark-to-market values of multiple rate contracts with a single counterparty [5] to determine one current exposure relative to that counterparty. In April 1993 the BSC proposed a revision to the Accord, endorsed by the G–10 Governors in July 1994, that permits institutions to net positive and negative mark-to-market values of rate contracts subject to a qualifying, legally enforceable, bilateral netting arrangement. Under the revision to the Accord, institutions with qualifying netting arrangements could replace the gross current exposure of a set of contracts included in such an arrangement with a single net current exposure for purposes of calculating the credit equivalent amount for the included contracts. If the net market value is positive, then that market value equals the current exposure for the netting contract. If the net market value is zero or negative, then the current exposure is zero.

On July 25, 1994, the FDIC issued a notice of proposed rulemaking to amend its risk-based capital guidelines in accordance with the BSC April 1993 proposal. 59 FR 37726, July 25, 1994.[6] Generally, under the proposal, a bilateral netting arrangement would be recognized for risk-based capital purposes only if the netting arrangement is legally enforceable. The bank would have to have a legal opinion(s) to this effect. That proposal is consistent with the final July 1994 change to the Accord.

B. Potential Future Exposure

The second part of the credit equivalent amount, potential future exposure, is an estimate of the additional exposure that may arise over the remaining life of the contract as a result of fluctuations in prices or rates. Such changes may increase the market value of the contract in the future and, therefore, increase the cost of replacing it if the counterparty subsequently defaults.

The add-on for potential future exposure is estimated by multiplying the notional principal amount [7] of the underlying contract by a credit conversion factor that is determined by the remaining maturity of the contract and the type of contract. The existing set of conversion factors used to calculate potential future exposure, referred to as the add-on matrix, is as follows:

Remaining maturity	Interest rate contracts (percent)	Exchange rate contracts (percent)
One year or less	0	1.0
Over one year	0.5	5.0

The conversion factors were determined through simulation studies that estimated the potential volatility of interest and exchange rates and analyzed the implications of movements in those rates for the replacement costs of various types of interest rate and exchange rate contracts. The simulation studies were conducted only on rate contracts, because at the time the Accord was being developed activity in the derivatives market was for the most part limited to these types of transactions. The analysis produced probability distributions of potential replacement costs over the remaining life of matched pairs of rate contracts.[8] Potential future exposure was then defined in terms of confidence limits for these distributions. The conversion factors were intended to be a compromise between precision, on the one hand, and complexity and burden, on the other.[9]

The add-on for potential future exposure is calculated for all contracts, regardless of whether the market value is zero, positive, or negative, or whether the current exposure is calculated on a gross or net basis. The add-on will always be either a positive number or zero. The recent revision to the Accord to recognize netting for the calculation of current exposure does not affect the calculation of potential future exposure, which generally continues to be calculated on a gross basis. This means that an add-on for potential future exposure is calculated separately for each individual contract subject to the netting arrangement and then these individual future exposures are added together to arrive at a gross add-on for potential future exposure. For contracts subject to a qualifying bilateral netting arrangement in accordance with the newly adopted Accord changes, the gross add-on for potential future exposure would be added to the net current exposure to arrive at one credit equivalent amount for the contracts subject to the netting arrangement.

The original Basle Accord noted that the credit conversion factors in the add-on matrix were provisional and would be subject to revision if volatility levels or market conditions changed.

II. Basle Proposals for the Treatment of Potential Future Exposure

Since the original Accord was adopted, the derivatives market has grown and broadened. The use of certain types of derivative instruments not specifically addressed in the Accord—notably commodity, precious metal, and equity-linked transactions [10]—has become much more widespread. As a result of continued review of the method for calculating the add-on for potential future exposure, in July 1994 the BSC issued two proposals for public consultation.[11] The first proposal would expand the matrix of add-on factors used to calculate potential future exposure to take into account innovations in the derivatives market. The second proposal would recognize reductions in the potential future exposure of derivative contracts that result from entering into bilateral netting arrangements. The second proposal is an extension of the recent revision to the Accord recognizing bilateral netting arrangements for purposes of calculating current exposure and would formally extend the recognition of netting arrangements to equity, precious metals and other commodity derivative contracts. The consultation period for these BSC proposals is scheduled to end on October 10, 1994.

[5] Netting by novation however, was recognized. Netting by novation is accomplished under a written bilateral contract providing that any obligation to deliver a given currency on a given date is automatically amalgamated with all other obligations for the same currency and value date. The previously existing contracts are extinguished and a new contract, for the single net amount, is legally substituted for the amalgamated gross obligations.

[6] The Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency issued a similar joint netting proposal on May 20, 1994 and the OTS issued its netting proposal on June 14, 1994.

[7] The notional principal amount, or value, is a reference amount of money used to calculate payment streams between the counterparties. Principal amounts generally are not exchanged in single-currency interest rate swaps, but generally are exchanged in foreign exchange contacts (including cross-currency interest rate swaps).

[8] A matched pair is a pair of contracts with identical terms, with the bank the buyer of one of the contracts and the seller of the other.

[9] The methodology upon which the statistical analyses were based is described in detail in a technical working paper entitled "Potential Credit Exposure on Interest Rate and Foreign Exchange Rate Related Instruments." This paper is available upon request from the FDIC's Reading Room by calling (202) 898–8785.

[10] In general terms, these are off-balance sheet transactions that have a return, or a portion of their return, linked to the price of a particular commodity, precious metal, or equity or to an index of commodity, precious metal or equity prices.

[11] The proposals are contained in a paper from the BSC entitled "The Capital Adequancy Treatment of the Credit Risk Associated with Certain Off-Balance Sheet Items" that is available upon request from FDIC's Reading Room by calling (202) 898—8785.

A. Expansion of Add-On Matrix

A recently concluded BSC review of the add-on for potential future exposure indicated that the current add-on factors used to calculate the potential future exposure amount may produce insufficient capital for certain types of derivative instruments, in particular, long-dated interest rate contracts, commodity contracts, and equity-index contracts. The BSC review indicated that the current add-on factors do not adequately address the full range of contract structures and the timing of cash flows. The review also showed that the conversion factors many institutions are using to calculate potential future exposure for commodity, precious metal, and equity contracts could result in insufficient capital coverage in view of the volatility of the indices or prices on the underlying assets from which these contracts derive their value.[12]

The BSC concluded that it was not appropriate to address these problems with a significant departure from the existing methodology used in the Accord. The BSC decided that it would be appropriate to preserve the conversion factors existing in the Accord and add new conversion factors. Consequently, the revision proposed by the BSC retains the existing conversion factors for rate contracts but applies new higher conversion factors to such contracts with remaining maturities of five years and over.[13] The proposal also introduces conversion factors specifically applicable to commodity, precious metal, and equity contracts. The new conversion factors were determined on the basis of simulation studies that used the same general approach that generated the original add-on conversion factors.[14]

The proposed matrix is set forth below:

CONVERSION FACTOR MATRIX*

[Numbers in percent]

Residual maturity	Interest rate	Foreign exchange and gold	Equity**	Precious metals, except gold	Other commododities
Less than one year	0.0	1.0	6.0	7.0	12.0
One to five years	0.5	5.0	8.0	7.0	12.0
Five years or more	1.5	7.5	10.0	8.0	15.0

* For contracts with multiple exchanges of principal, the factors are to be multiplied by the number of remaining payments in the contract.

** For contracts that automatically reset to zero value following a payment, the remaining maturity is set equal to the time remaining until the next payment.

Gold is included within the foreign exchange column because the price volatility of gold has been found to be comparable to the exchange rate volatility of major currencies. In addition, the BSC determined that gold's role as a financial asset distinguishes it from other precious metals. The proposed matrix is designed to accommodate the different structures of contracts, as well as the observed disparities in the volatilities of the associated indices or prices of the underlying assets.

Two footnotes are attached to the matrix to address two particular contract structures. The first relates to contracts with multiple exchanges of principal. Since the level of potential future exposure rises generally in proportion to the number of remaining exchanges, the conversion factors are to be multiplied by the number of remaining payments (that is, exchanges of principal) in the contract. This treatment is intended to ensure that the full level of potential future exposure is adequately covered. The second footnote applies to equity contracts that automatically reset to zero each time a payment is made. The credit risk associated with these contracts is similar to that of a series of shorter contracts beginning and ending at each reset date. For this type of equity contract the remaining maturity is set equal to the time remaining until the next payment.

While the capital charges resulting from the application of the new proposed conversion factors may not provide complete coverage for risks associated with any single contract, the BSC believes the factors will provide a reasonable level of prudential coverage for derivative contracts on a portfolio basis. Like the original matrix, the proposed expanded matrix is designed to provide a reasonable balance between precision, and complexity and burden.

B. Recognition of the Effects of Netting

The simulation studies used to generate the conversion factors for potential future exposure analyzed the implications of underlying rate and price movements on the current exposure of contracts without taking into account reductions in exposure that could result from legally enforceable netting arrangements. Thus, the conversion factors are most appropriately applied to non-netted contracts, and when applied to legally enforceable netted contracts, they could in some cases, overstate the potential future exposure.

Comments provided during the consultative process of revising the Basle Accord to recognize qualifying bilateral netting arrangements and further research conducted by the BSC, have suggested that netting arrangements can reduce not only a banking organization's current exposure for the transactions subject to the netting arrangement, but also its potential future exposure for those transactions.[15]

As a result, in July 1994 the BSC issued a proposal to incorporate into the calculation of the add-on for potential

[12] While commodity, precious metal, and equity contracts were not explicity covered by the original Accord, as the use of such contracts became more prevalent, many G–10 bank supervisors, including U.S. banking supervisors, have informally permitted institutions to apply the conversion factors for exchange rate contracts to these types of transactions pending development of a more appropriate treatment.

[13] The conversion factors for rate contracts with remaining maturities of one to five years are currently applied to any contracts with a remaining maturity of over one year.

[14] The methodology and results of the statistical analyses are summarized in a paper entitled "The Calculation of Add-Ons for Derivative Contracts: The Expanded Matrix Approach" which is available upon request from the FDIC's Reading Room by calling (202) 898–8785.

[15] While current exposure is intended to cover an organization's credit exposure at one point in time, potential future exposure provides an estimate of possible increases in future replacement cost, in view of the volatility of current exposure over the remaining life of the contract. The greater the tendency of the current exposure to fluctuate over time, the greater the add-on for potential future exposure should be to cover expected fluctuations.

future exposure a method for recognizing the risk-reducing effects of qualifying netting arrangements. Under the proposal, institutions could recognize these effects only for transactions subject to legally enforceable bilateral netting arrangements that meet the requirements of netting for current exposure as set forth in the recent amendment to the Accord.

Depending on market conditions and the characteristics of a bank's derivative portfolio, netting arrangements can have substantial effects on a bank's potential future exposure to multiple derivative contracts it has entered into with a single counterparty. Should the counterparty default at some future date, the bank's exposure would be limited to the net amount the counterparty owes on the date of default rather than the gross current exposure of the included contracts. By entering into a netting arrangement, a bank may reduce not only its current exposure, but also its future exposure as well. Nevertheless, while in many circumstances a netting arrangement can reduce the potential future exposure of a counterparty portfolio, this is not always the case.[16]

The most important factors influencing whether a netting arrangement will have an effect on potential future exposure are the volatilities of the current exposure to the counterparty on both a gross and net basis.[17] The volatilities of net current exposure and gross current exposure of the portfolio may not necessarily be the same. Volatility of gross current exposure is influenced primarily by the fluctuations of the market values of positively valued contracts. Volatility of net current exposure on the other hand, is influenced by the fluctuations of the market values of all contracts within the portfolio. In those cases where net current exposure has a tendency to fluctuate more over time than gross current exposure, a netting arrangement will not reduce the potential future exposure. However, in those situations where net current exposure has a tendency to fluctuate less over time than gross current exposure, a netting arrangement can reduce the potential future exposure.

Net current exposure is likely to be less volatile relative to the volatility of gross current exposure when the portfolio of contracts as a whole is more diverse than the subset of positively valued contracts. When a netting arrangement is applied to a diversified portfolio and the positively valued contracts within the portfolio as a group are less diversified than the overall portfolio, then the effect of the netting arrangement will be to reduce the potential future exposure for the portfolio.

The BSC has studied and analyzed several alternatives for taking into account the effects of netting when calculating the capital charge for potential future exposure. In particular, the BSC reviewed one general method proposed by commenters to the April 1993 netting proposal. This method would reduce the amount of the add-on for potential future exposure by multiplying the calculated gross add-on by the ratio of the portfolio's net current exposure to gross current exposure (the net-to-gross ratio or NGR). The NGR is used as a proxy for the risk-reducing effects of the netting arrangement on the potential future exposure. The more diversified the portfolio, the lower the net current exposure tends to be relative to gross current exposure.

The BSC incorporated this method into its proposal. However, given that there are portfolio-specific situations in which the NGR does not provide a good indication of these effects, the BSC proposal gives only partial weight to the effects of the NGR on the add-on for potential future exposure. The proposed method would average the amount of the add-on as currently calculated (A_{gross}) and the same amount multiplied by the NGR to arrive at a reduced add-on (A_{net}) for contracts subject to qualifying netting arrangements in accordance with the requirements set forth in the recently amended Accord. This formula is expressed as:

$A_{net} = .5(A_{gross} + (NGR * A_{gross}))$.

For example, a bank with a gross current exposure of 500,000, a net current exposure of 300,000, and a gross add-on for potential future exposure of 1,200,000, would have an NGR of .6 (300,000/500,000) and would calculate A_{net} as follows:

$.5(1,200,000 + (.6 * 1,200,000))$

$A_{net} = 960,000$

For banks with an NGR of 50 percent, the effect of this treatment would be to permit a reduction in the amount of the add-on by 25 percent. The BSC believes that most dealer banks are likely to have an NGR in the vicinity of 50 percent.

The BSC proposal does not specify whether the NGR should be calculated on a counterparty-by-counterparty basis or on an aggregate basis for all transactions subject to qualifying, legally enforceable netting arrangements. The proposal requests comment on whether the choice of method could bias the results and whether there is a significant difference in calculation burden between the two methods.

The BSC proposal also acknowledges that simulations using bank's internal models for measuring credit risk exposure would most likely produce the most accurate determination of the effect of netting arrangements on potential future exposures. The proposal states that the use of such models would be considered at some future date.

C. The FDIC Proposal

In light of the BSC proposal, the FDIC believes that it is appropriate to seek comment on proposed revisions to the calculation of the add-on for potential future exposure for derivative contracts. Therefore, the FDIC is proposing to amend its risk-based capital guidelines for state nonmember banks to expand the matrix of conversion factors, and to permit institutions that make use of qualifying netting arrangements to recognize the effects of those netting arrangements in the calculation of the add-on for potential future exposure. The second part of the proposed amendment is contingent on the adoption of a final amendment to the FDIC's risk-based capital guidelines to recognize bilateral close-out netting arrangements and would formally extend this recognition to commodity, precious metals, and equity derivative contracts.

With regard to the portion of the proposal to expand the conversion factor matrix, the FDIC is proposing the same conversion factors set forth in the BSC proposal. The FDIC agrees with the BSC that the existing conversion factors applicable to long-dated transactions do not provide sufficient capital for the risks associated with those types of contracts. The FDIC also agrees with the BSC that the conversion factors for foreign exchange transactions are significantly too low for commodity, precious metal, and equity contracts due to the volatility of the associated indices or the prices on the underlying assets.[18]

[16] For purposes of this discussion, a portfolio refers to a set of contracts with a single counterparty. A bank's global portfolio refers to all of the contracts in the institution's derivatives portfolio that are subject to qualifying netting arrangements.

[17] Volatility in this discussion is the tendency of the market value of a contract to vary or fluctuate over time. A highly volatile portfolio would have a tendency to fluctuate significantly over short periods of time. One of the most important factors influencing a portfolio's volatility is the correlation of the contracts within the portfolio, that is, the degree to which the contracts in the portfolio respond similarly to changing market conditions.

[18] Similar to the BSC proposal, the FDIC's proposed amendment specifies that for equity

Continued

The FDIC is proposing the same formula as the BSC proposal to calculate a reduction in the add-on for potential future exposure for contracts subject to qualifying netting contracts. The FDIC recognizes several advantages with this formula. First, the formula uses bank-specific information to calculate the NGR. The NGR is simple to calculate and uses readily available information. The FDIC believes the use of the averaging factor of 0.5 is an important aspect of the proposed formula because it means the add-on for potential future exposure can never be reduced to zero and banks will always hold some capital against derivative contracts, even in those instances where the net current exposure is zero.

The FDIC is seeking comment on all aspects of this proposal. As mentioned earlier, the BSC proposal seeks comment on whether the NGR should be calculated on a counterparty-by-counterparty basis, or on a global basis for all contracts subject to qualifying bilateral netting arrangements. The FDIC's proposed regulatory language would require the calculation of a separate NGR for each counterparty with which it has a qualifying netting contract. However, the FDIC is also seeking comment as to which method of calculating the NGR would be most efficient and appropriate for institutions with numerous qualifying bilateral netting arrangements. With either calculation method the NGR would be applied separately to adjust the add-on for potential future exposure for each netting arrangement. The FDIC notes that some preliminary findings indicate that a global NGR may be less burdensome to apply since the same NGR would be used for each counterparty with a netting arrangement, but counterparty specific NGRs may provide a more accurate indication of the credit risk associated with each counterparty.

Regulatory Flexibility Act Analysis

The FDIC does not believe that adoption of this proposal would have a significant economic impact on a substantial number of small business entities (in this case, small banks), in accord with the spirit and purposes of the Regulatory Flexibility Act (5 U.S.C 601 et. seq.). In this regard, while some small banks with limited derivative portfolios may experience an increase in capital charges, for most banks the overall effect of the proposal will be to reduce regulatory burden and to reduce the capital charge for certain transactions.

Paperwork Reduction Act

The FDIC has determined that its proposed amendments, if adopted, would not increase the regulatory paperwork burden of state nonmember banks pursuant to the provisions of the paperwork Reduction Act (44 U.S.C. 3501 et. seq.).

List of Subjects in 12 CFR Part 325

Bank deposit insurance, Banks, banking, Capital adequacy, Reporting and recordkeeping requirements, Savings associations, State nonmember banks.

For the reasons set forth in the preamble, the Board of Directors of the FDIC proposes to amend 12 CFR part 325 as follows:

PART 325—CAPITAL MAINTENANCE

1. The authority citation for part 325 continues to read as follows:

Authority: 12 U.S.C. 1815(a), 1815(b), 1816, 1818(a), 1818(b), 1818(c), 1818(t), 1819 (Tenth), 1828(c), 1828(d), 1828(i), 1828(n), 1828(o), 1831o, 3907, 3909; Pub. L. 102–233, 105 Stat. 1761, 1789, 1790 (12 U.S.C. 1831n note) Pub. L. 102–242, 105 Stat. 2236, 2355, 2386 (12 U.S.C. 1828 note).

2. In appendix A to part 325, section II is amended by:

a. Revising the last sentence in section II.C. Category 3;

b. Redesignating footnotes 36 through 40 as footnotes 37 through 41;

c. Adding new footnote 35 at the end of the introductory text of section II.D.; and

d. Revising the heading and the introductory text of section II.E. (preceding paragraph E.1.) to read as follows:

APPENDIX A TO PART 325—STATEMENT OF POLICY ON RISK-BASED CAPITAL

* * * * *

II. * * *

C. * * *

Category 3 * * * In addition, the credit equivalent amount of derivative contracts that do not qualify for a lower risk weight are assigned to the 50 percent risk category.

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D. * * *[35] * * *

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E. Derivative Contracts (Interest Rate, Exchange Rate, Commodity and Equity Derivative Contracts)

Credit equivalent amounts are computed for each of the following off-balance-sheet derivative contracts:

Interest Rate Contracts

(1) Single currency interest rate swaps.

(2) Basis swaps

(3) Forward rate agreements.

(4) Interest rate options (including caps, collars, and floors purchased).

(5) Any other instrument that gives rise to similar credit risks (including when-issued securities and forward deposits accepted).

Exchange Rate Contracts

(1) Cross-currency interest rate swaps.

(2) Forward foreign exchange contracts

(3) Currency options purchased.

(4) Any other instrument that gives rise to similar credit risks.

Commodity (including precious metal) or Equity Derivative Contracts

(1) Commodity or equity linked swaps.

(2) Commodity or equity linked options purchased.

(3) Forward commodity or equity linked contracts.

(4) Any other instrument that gives rise to similar credit risks.

Exchange rate contracts with an original maturity of fourteen calendar days or less and derivative contracts traded on exchanges that require daily payment of variation margin may be excluded from the risk-based ratio calculation. Over-the-counter options purchased, however, are included and treated in the same way as other derivative contracts.

* * * * *

3. In Appendix A to part 325, section II.E.1., as that section was proposed to be revised at 59 FR 37726, July 25, 1994, is revised to read as follows:

II. * * *

E. * * *

1. *Credit Equivalent Amounts for Derivative Contracts.* The credit equivalent amount of a derivative contract that is not subject to a qualifying bilateral netting contract in accordance with section II.E.3. of this appendix A is equal to the sum of (i) the current exposure (which is equal to the mark-to-market value,[41] if positive, and is sometimes referred to as the replacement cost) of the contract and (ii) an estimate of the potential future credit exposure over the remaining life of the contract.

The current exposure is determined by the mark-to-market value of the contract. If the mark-to-market value is positive, then the current exposure is equal to that mark-to-market value. If the mark-to-market value is zero or negative, then the current exposure is zero.

The potential future credit exposure of a contract, including contracts with negative mark-to-market values, is estimated by

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contracts that automatically reset to zero value following a payment, the remaining maturity is set equal to the time remaining until the next payment. Also, for contracts with multiple exchanges of principal, the conversion factors are to be multiplied by the number of remaining payments in the contract.

[35] The sufficiency of collateral and guarantees for off-balance-sheet items is determined by the market value of the collateral or the amount of the guarantee in relation to the face amount of the item, except for derivative contracts, for which this determination is generally made in relation to the credit equivalent amount. Collateral and guarantees are subject to the same provisions noted under section II.B.

[41] Mark-to-market values are measured in dollars, regardless of the currency or currencies specified in the contract and should reflect changes in both underlying rates, prices and indices, and counterparty credit quality.

multiplying the notional principal amount of the contract by one of the following credit conversion factors, as appropriate:

CONVERSION FACTOR MATRIX [A]

[Numbers in percent]

Residual maturity	Interest rate	Exchange rate and gold	Equity [B]	Precious metals, except gold	Other commodities
Less than one year	0.0	1.0	6.0	7.0	12.0
One to five years	0.5	5.0	8.0	7.0	12.0
Five years or more	1.5	7.5	10.0	8.0	15.0

[A] For contracts with multiple exchanges of principal, the factors are to be multiplied by the number of remaining payments in the contract.
[B] For contracts that reset to zero value following a payment, the remaining maturity is set equal to the time until the next payment.

No potential future exposure is calculated for single currency interest rate swaps in which payments are made based upon two floating rate indices (so called floating/floating or basis swaps); the credit exposure on these contracts is evaluated solely on the basis of their mark-to-market values.

4. In Appendix A to part 325, section II.E.2, as that section was proposed to be revised at 59 FR 37726, July 25, 1994, is revised to read as follows:

II. * * *

E. * * *

2. *Risk Weights and Avoidance of Double Counting.* Once the credit equivalent amount for a derivative contract, or a group of derivative contracts, has been determined, that amount is assigned to the risk category appropriate to the counterparty, or, if relevant, the guarantor or the nature of any collateral. However, the maximum weight that will be applied to the credit equivalent amount of such contracts is 50 percent.

In certain cases, credit exposures arising from the derivative contracts covered by these guidelines may already be reflected, in part, on the balance sheet. To avoid double counting such exposures in the assessment of capital adequacy and, perhaps, assigning inappropriate risk weights, counterparty credit exposures arising from the types of instruments covered by these guidelines may need to be excluded from balance sheet assets in calculating banks' risk-based capital ratios.

The FDIC notes that the conversion factors set forth in section II.E.1. of appendix A, which are based on observed volatilities of the particular types of instruments, are subject to review and modification in light of changing volatilities or market conditions.

Examples of the calculation of credit equivalent amounts for these types of contracts are contained in table IV of this appendix A.

5. In Appendix A to part 325, section II.E.3, as that section was proposed to be added at 59 FR 37726, July 25, 1994, is revised to read as follows:

II. * * *

E. * * *

3. *Netting.* For purposes of this appendix A, netting refers to the offsetting of positive and negative mark-to-market values when determining a current exposure to be used in the calculation of a credit equivalent amount. Any legally enforceable form of bilateral netting (that is, netting with a single counterparty) of derivative contracts is recognized for purposes of calculating the credit equivalent amount provided that:

* * * * *

(d) The bank maintains in its files documentation adequate to support the netting of derivative contracts, including a copy of the bilateral netting contract and necessary legal opinions.

A contract containing a walkaway clause is not eligible for netting for purposes of calculating the credit equivalent amount.[42]

By netting individual contracts for the purpose of calculating its credit equivalent amount, a bank represents that it has met the requirements of this appendix A and all the appropriate documents are in the bank's files and available for inspection by the FDIC. Upon determination by the FDIC that a bank's files are inadequate or that a netting contract may not be legally enforceable under any one of the bodies of law described in paragraphs (b) (i) through (iii) of this section, underlying individual contracts may be treated as though they were not subject to the netting contract.

The credit equivalent amount of derivative contracts that are subject to a qualifying bilateral netting contract is calculated by adding (i) the net current exposure of the netting contract and (ii) the sum of the estimates of potential future exposure for all individual contracts subject to the netting contract, adjusted to take into account the effects of the netting contract.

The net current exposure is the sum of all positive and negative mark-to-market values of the individual contracts subject to the netting contract. If the net sum of the mark-to-market values is positive, then the net current exposure is equal to that sum. If the net sum of the mark-to-market values is zero or negative, then the net current exposure is zero.

The sum of the estimates of potential future exposure for all individual contracts subject to the netting contract (A_{gross}), adjusted to reflect the effects of the netting contract (A_{net}), is determined through application of a formula. The formula, which employs the ratio of the net current to the gross current exposure (NGR), is expressed as:

$A_{net} = .5(A_{gross} + (NGR * A_{gross}))$

Gross potential future exposure, or A_{gross}, is calculated by summing the estimates of potential future exposure (determined in accordance with section II.E.1. of this appendix A) for each individual contract subject to the qualifying bilateral netting contract.[43] The NGR is determined as the ratio of the net current exposure of the netting contract to the gross current exposure of the netting contract. The gross current exposure is the sum of the current exposures of all individual contracts subject to the netting contract calculated in accordance with section II.E.1. of this appendix A. The effect of this treatment is that A_{net} is the average of A_{gross} and A_{gross} adjusted by the NGR.

6. In Appendix A to part 325, the chart in Table III and its heading, as that section was proposed to be amended at 59 FR 37726, July 25, 1994, is revised to read as follows:

Table III. * * *

* * * * *

Credit Conversion for Derivative Contracts

* * * * *

[42] For purposes of this section, a walkaway clause means a provision in a netting contract that permits a non-defaulting counterparty to make lower payments than it would make otherwise under the contract, or no payments at all, to a defaulter or to the estate of a defaulter, even if a defaulter or the estate of a defaulter is a net creditor under the contract.

[43] For purposes of calculating gross potential future credit exposure for foreign exchange contracts and other similar contracts in which notional principal is equivalent to cash flows, total notional principal is defined as the net receipts to each party falling due on each value date in each currency.

CONVERSION FACTOR MATRIX [A]

[Numbers in percent]

Residual maturity	Interest rate	Exchange rate	Equity [B]	Precious metals	Other commodities
Less than one year	0.0	1.0	6.0	7.0	12.0
One to five years	0.5	5.0	8.0	7.0	12.0
Five years or more	1.5	7.5	10.0	8.0	15.0

[A] For contracts with multiple exchanges of principal, the factors are to be multiplied by the number of remaining payments in the contract.
[B] For contracts that reset to zero value following a payment, the remaining maturity is set equal to the time until the next payment.

* * * * *

6. In Appendix A to part 325, Table IV, as that table was proposed to be added at 59 FR 37726, July 25, 1994, is revised to read as follows:

TABLE IV.—CALCULATION OF CREDIT EQUIVALENT AMOUNTS FOR DERIVATIVE CONTRACTS

Potential exposure	+		=	Credit equivalent amount		
Type of contract (remaining maturity)	Notional principal (dollars)	Current exposure	Potential Exposure (dollars)	Market-to market value	Current exposure (dollars)	Credit equivalent amount
(1) 120-Day Forward Foreign Exchange	5,000,000	.01	50,000	100,000	100,000	150,000
(2) 6-Year Forward Foreign Exchange	6,000,000	.075	450,000	−120,000	0	450,000
(3) 3-Year Interest Rate Swap	10,000,000	.005	50,000	200,000	200,000	250,000
(4) 1-Year Oil Swap	10,000,000	.12	1,200,000	−250,000	0	1,200,000
(5) 7-Year Interest Rate Swap	20,000,000	.015	300,000	−1,300,000	0	300,000
Total	....	....	2,050,000	....	300,000	2,350,000

If contracts (1) through (5) above are subject to a qualifying bilateral netting contract, then the following applies:

	Potential future exposure (from above)		Net current exposure*		Credit equivalent amount
(1)	50,000				
(2)	450,000				
(3)	50,000				
(4)	1,200,000				
(5)	300,000				
Total	2,050,000	+	0	=	2,050,000

*The total of the mark-to-market values from above is −1,370,000. Since this is a negative amount, the net current exposure is zero.

To recognize the effects of netting on potential future exposure, the following formula applies:

$A_{net} = .5\ (A_{gross} + (NGR * A_{gross}))$

In the above example:

$NGR = 0\ (0/300{,}000)$

$A_{net} = .5\ (2{,}050{,}000 + (0 * 2{,}050{,}000))$

$A_{net} = 1{,}025{,}000$

Credit Equivalent Amount: 1,025,000 + 0 = 1,025,000

If the net current exposure was a positive amount, for example, $200,000, the credit equivalent amount would be calculated as follows:

$NGR = .67\ (200{,}000/300{,}000)$

$A_{net} = .5(2{,}050{,}000 + (.67 * 2{,}050{,}000))$

$A_{net} = 1{,}711{,}750$

Credit Equivalent Amount: 1,711,750 + 200,000 = 1,911,750

By order of the Board of Directors.

Dated at Washington, D.C. this 27 day of September, 1994.

Federal Deposit Insurance Corporation

Robert E. Feldman,

Acting Executive Secretary.

[FR Doc. 94–25662 Filed 10–18–94; 8:45 am]

BILLING CODE 6714–01–P

DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 39

[Docket No. 93–NM–207–AD]

Airworthiness Directives; Canadair Model CL–600–1A11, –2A12, and –2B16 Series Airplanes

AGENCY: Federal Aviation Administration, DOT.

ACTION: Supplemental notice of proposed rulemaking; reopening of comment period.

SUMMARY: This document revises an earlier supplemental proposed airworthiness directive (AD), applicable to certain Canadair Model CL–600–1A11, –2A12, and –2B16 series airplanes, that would have required a functional check of the idle stop function of the engine throttle quadrant; repair or replacement, if necessary; and eventual replacement of the engine throttle quadrant. That proposal was prompted by reports of unintentional engine shutdown on certain of these airplanes due to problems associated with operation of the engine throttle quadrant. This action further revises the proposed rule by adding a second type

of test of the engine throttle quadrant to determine if the throttle levers bypass the idle stop into the shut-off position. The actions specified by this proposed AD are intended to ensure the proper operation of the throttle quadrant so as to prevent inadvertent shutdown of an engine while the airplane is taxiing or in flight.

DATES: Comments must be received by November 23, 1994.

ADDRESSES: Submit comments in triplicate to the Federal Aviation Administration (FAA), Transport Airplane Directorate, ANM–103, Attention: Rules Docket No. 93–NM–207–AD, 1601 Lind Avenue, SW., Renton, Washington 98055–4056. Comments may be inspected at this location between 9:00 a.m. and 3:00 p.m., Monday through Friday, except Federal holidays.

The service information referenced in the proposed rule may be obtained from Bombardier, Inc., Canadair Aerospace Group, P.O. Box 6087, Station Centre-ville, Quebec H3C 3G9, Canada. This information may be examined at the FAA, Transport Airplane Directorate, 1601 Lind Avenue, SW., Renton, Washington; or at the FAA, Engine and Propeller Directorate, New York Aircraft Certification Office, 181 South Franklin Avenue, Valley Stream, New York.

FOR FURTHER INFORMATION CONTACT: Raymond J. O'Neill, Aerospace Engineer, Propulsion Branch, ANE–174, FAA, Engine and Propeller Directorate, New York Aircraft Certification Office, 181 South Franklin Avenue, Room 202, Valley Stream, New York 11581; telephone (516) 791–7421; fax (516) 791–9024.

SUPPLEMENTARY INFORMATION:

Comments Invited

Interested persons are invited to participate in the making of the proposed rule by submitting such written data, views, or arguments as they may desire. Communications shall identify the Rules Docket number and be submitted in triplicate to the address specified above. All communications received on or before the closing date for comments, specified above, will be considered before taking action on the proposed rule. The proposals contained in this notice may be changed in light of the comments received.

Comments are specifically invited on the overall regulatory, economic, environmental, and energy aspects of the proposed rule. All comments submitted will be available, both before and after the closing date for comments, in the Rules Docket for examination by interested persons. A report summarizing each FAA-public contact concerned with the substance of this proposal will be filed in the Rules Docket.

Commenters wishing the FAA to acknowledge receipt of their comments submitted in response to this notice must submit a self-addressed, stamped postcard on which the following statement is made: "Comments to Docket Number 93–NM–207–AD." The postcard will be date stamped and returned to the commenter.

Availability of NPRMs

Any person may obtain a copy of this NPRM by submitting a request to the FAA, Transport Airplane Directorate, ANM–103, Attention: Rules Docket No. 93–NM–207–AD, 1601 Lind Avenue, SW., Renton, Washington 98055–4056.

Discussion

A proposal to amend part 39 of the Federal Aviation Regulations (14 CFR part 39) to add an airworthiness directive (AD), applicable to certain Canadair Model CL–600–1A11, –2A12, and –2B16 series airplanes, was published as a supplemental notice of proposed rulemaking (NPRM) in the **Federal Register** on June 28, 1994 (59 FR 33233). That supplemental NPRM would have required a functional check of the idle stop function of the throttle quadrant; repair or replacement of the throttle quadrant if the check failed; and the eventual replacement of the throttle quadrant with a new model. In addition, that supplemental NPRM expanded the applicability of the initially-issued NPRM to include additional airplanes that were found to be subject to the addressed unsafe condition.

That supplemental NPRM was prompted by reports of unintentional engine shutdown that occurred on Model CL–600–2A12 and –2B16 series airplanes when a throttle lever over-rode the idle stop during throttle retardation, due to a quick, sharp pull on the throttle levers, and the throttle lever consequently moved directly to the shut-off position. The proposed functional check (hereafter called "the abrupt-movement check") was intended to ensure that such unintentional shutdowns of engines would not occur while the airplane is taxiing or in flight. The abrupt-movement check procedures are described in Canadair Challenger Service Bulletins A600–0629 and A601–0410, both dated November 1, 1993.

Subsequent to the issuance of that supplemental NPRM, the FAA became aware that a necessary requirement, which was previously proposed in the initially-issued NPRM, was incorrectly omitted from the supplemental NPRM. The original NPRM was published in the **Federal Register** on February 9, 1994, (59 FR 5966). That action would have required operators to test the engine throttle quadrant to determine if the throttle levers bypass the idle stop into the shut-off position due to side loads on the throttle levers; quadrants that failed the test (hereafter called "the side-load test") would be required to be modified or replaced. Those actions would have been required to be accomplished in accordance with the instructions contained in Canadair Alert Service Bulletin A600–0615, dated June 10, 1992 (for Model CL–600–1A11 series airplanes); or Canadair Alert Service Bulletin A601–0374, Revision 1, dated September 30, 1992 (for Models CL–600–2A12 and CL–600–2B16 series airplanes).

The FAA has determined that performance of this side-load test is necessary in order to adequately address the unsafe condition presented by the problems identified with the operation of the engine throttle quadrant.

Operators should note that the originally-issued NPRM would have required that throttle quadrants failing the side-load test be modified in accordance with the Canadair service bulletins released in 1992 (referred to above). However, in accordance with the recommendations of the Canadair service bulletins released in November 1993 (referred to above), throttle quadrants that failed the abrupt-movement check would be replaced with a new unit. The FAA has determined that it is not logical to require that the throttle quadrants be modified if they fail the side-load test and subsequently be replaced by a new unit if they fail the abrupt-movement check. The FAA has determined, instead, that both the side-load test and the abrupt-movement check must be performed, and units that fail either test must be replaced in accordance with the Canadair service bulletins dated November 1993. (Units that pass the tests would be required eventually to be replaced at a later time.)

Additionally, the compliance time for the proposed eventual replacement of the engine throttle quadrant on all airplanes was incorrectly expressed in the previous supplemental NPRM as "1,200 flight hours." The compliance time for this proposed requirement should have been specified as "4,500 hours time-in-service." (The "1,200" figure actually represented the number of landings that is approximately equivalent to 4,500 hours time-in-service for the majority of the affected fleet.)

This airplane model is manufactured in Canada and is type certificated for operation in the United States under the provisions of § 21.29 of the Federal Aviation Regulations (14 CFR 21.29) and the applicable bilateral airworthiness agreement.

Since an unsafe condition has been identified that is likely to exist or develop on other airplanes of the same type design registered in the United States, this supplemental NPRM would require:

1. A one-time test of the engine throttle quadrant to determine if side loads on the throttles will cause the throttle levers to bypass the idle stop into the shut-off position, and replacement of the throttle quadrant if it fails this test;

2. A one-time functional check of the engine throttle quadrant to determine if a quick, sharp pull on the throttles will cause the throttle levers to bypass the idle stop into the shut-off position, and replacement of the throttle quadrant if it fails this functional check; and

3. Replacement of the throttle quadrant as terminating action for the requirements of this AD.

Additionally, paragraph (e) of this supplemental NPRM indicates the corrected compliance time of "4,500 hours time-in-service" for replacement of the throttle quadrant. Expressing this compliance time in terms of "hours time-in-service" makes it consistent with the compliance terms for the other requirements of this proposed AD.

Since certain of these changes expand the scope of the previously proposed rule, the FAA has determined that it is necessary to reopen the comment period to provide additional opportunity for public comment.

Cost Impact

The FAA estimates that 150 airplanes of U.S. registry would be affected by this proposed AD.

The proposed side-loads test of the engine throttle quadrant would take approximately 17 work hours per airplane to accomplish the proposed actions, and that the average labor rate is $55 per work hour. Based on these figures, the total cost impact of this proposed requirement on U.S. operators is estimated to be $140,250, or $935 per airplane.

The proposed abrupt-movement check of the idle stop function of the throttle quadrant would take approximately 1 work hour per airplane to accomplish, at an average labor rate of $55 per work hour. Based on these figures, the total cost impact of the proposed functional check on U.S. operators is estimated to be $8,250, or $55 per airplane.

The proposed installation of a modified throttle quadrant would take approximately 10 work hours per airplane to accomplish, at an average labor rate of $55 per work hour. Required parts would be provided by the manufacturer at no cost to operators. Based on these figures, the total cost impact of the proposed installation on U.S. operators is estimated to be $82,500, or $550 per airplane.

Based on the figures discussed above, the total cost impact of this proposed AD on U.S. operators is estimated to be $231,000, or $1,540 per airplane. This total cost impact figure is based on assumptions that no operator has yet accomplished any of the proposed requirements of this AD action, and that no operator would accomplish those actions in the future if this AD were not adopted.

Regulatory Impact

The regulations proposed herein would not have substantial direct effects 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. Therefore, in accordance with Executive Order 12612, it is determined that this proposal would not have sufficient federalism implications to warrant the preparation of a Federalism Assessment.

For the reasons discussed above, I certify that this proposed regulation (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); and (3) if promulgated, 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. A copy of the draft regulatory evaluation prepared for this action is contained in the Rules Docket. A copy of it may be obtained by contacting the Rules Docket at the location provided under the caption ADDRESSES.

List of Subjects in 14 CFR Part 39

Air transportation, Aircraft, Aviation safety, Safety.

The Proposed Amendment

Accordingly, pursuant to the authority delegated to me by the Administrator, the Federal Aviation Administration proposes to amend part 39 of the Federal Aviation Regulations (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. App. 1354(a), 1421 and 1423; 49 U.S.C. 106(g); and 14 CFR 11.89.

§ 39.13 [Amended]

2. Section 39.13 is amended by adding the following new airworthiness directive:

Canadair: Docket 93–NM–207–AD.

Applicability: Model CL–600–1A11 series airplanes, serial numbers 1004 through 1085, inclusive, equipped with throttle quadrant part numbers 600–90601–69, –71, –73, –75, –77, and –79; Model CL–600–2A12 series airplanes, serial numbers 3001 through 3066, inclusive, equipped with throttle quadrant part numbers 600–90601–983, –987, –989, –1013, –1015, –1017, –1019, –1021, –1023, –1025, and –1027; and Model CL–600–2B16 series airplanes, serial numbers 5001 through 5139, inclusive, equipped with throttle quadrant part numbers 600–90601–983, –987, –989, –1013, –1015, –1017, –1019, –1021, –1023, –1025, and –1027; certificated in any category.

Compliance: Required as indicated, unless accomplished previously.

To prevent inadvertent shutdown of an engine while the airplane is taxiing or in flight, accomplish the following:

(a) Within 50 hours time-in-service after the effective date of this AD, perform a test of the engine throttle quadrant to determine if the throttle levers bypass the idle stop into the shut-off position, in accordance with Canadair Alert Service Bulletin A600–0615, dated June 10, 1992 (for Model CL–600–1A11 series airplanes); or Canadair Alert Service Bulletin A601–0374, Revision 1, dated September 30, 1992 (for Models CL–600–2A12 and CL–600–2B16 series airplanes), as applicable.

Note 1: Canadair Alert Service Bulletins A600–0615 and A601–0374 reference Sargent Aerospace Service Bulletins 43058–76–03 (for Model CL–600–1A11 series airplanes) and 43068–76–05 (for Model CL–600–2A12 and –2B16 series airplanes), both dated April 13, 1992, for additional service information.

(b) If the test required by paragraph (a) of this AD indicates that either throttle lever bypasses the idle stop into the shut-off position, prior to further flight, replace the throttle quadrant in accordance with Part B of the Accomplishment Instructions of Canadair Challenger Service Bulletin A600–0629, dated November 1, 1993 (for Model CL–600–1A11 series airplanes); or Canadair Challenger Service Bulletin A601–0410, dated November 1, 1993 (for Models CL–600–2A12 and –2B16 series airplanes); as applicable.

(c) Within 150 hours time-in-service after the effective date of this AD, perform a functional check of the idle stop function of the throttle quadrant in accordance with Part A of the Accomplishment Instructions of Canadair Challenger Service Bulletin A600–0629, dated November 1, 1993 (for Model CL–600–1A11 series airplanes); or Canadair

Challenger Service Bulletin A601–0410, dated November 1, 1993 (for Models CL–600–2A12 and –2B16 series airplanes); as applicable.

Note 2: Canadair Challenger Service Bulletins A600–0629 and A601–0410 reference Sargent Aerospace Service Bulletins 43058–76–04 (for Model CL–600–1A11 series airplanes) and 43068–76–06 (for Model CL–600–2A12 and –2B16 series airplanes), both dated March 24, 1993, for additional service information.

(d) If the functional check required by paragraph (c) of this AD indicates that the idle stop function of the throttle quadrant fails, prior to further flight, replace the throttle quadrant in accordance with Part B of the Accomplishment Instructions of Canadair Challenger Service Bulletin A600–0629 or A601–0410, both dated November 1, 1993, as applicable.

(e) Within 4,500 hours time-in-service after the effective date of this AD, replace the throttle quadrant in accordance with Part B of the Accomplishment Instructions of Canadair Challenger Service Bulletin A600–0629, dated November 1, 1993 (for Model CL–600–1A11 series airplanes); or Canadair Challenger Service Bulletin A601–0410, dated November 1, 1993 (for Models CL–600–2A12 and CL–600–2B16 series airplanes); as applicable. Such replacement constitutes terminating action for the requirements of this AD.

(f) An alternative method of compliance or adjustment of the compliance time that provides an acceptable level of safety may be used if approved by the Manager, Standardization Branch, ANM–113, FAA, Transport Airplane Directorate. Operators shall submit their requests through an appropriate FAA Principal Maintenance Inspector, who may add comments and then send it to the Manager, Standardization Branch, ANM–113.

Note 3: Information concerning the existence of approved alternative methods of compliance with this AD, if any, may be obtained from the Standardization Branch, ANM–113.

(g) Special flight permits may be issued in accordance with sections 21.197 and 21.199 of the Federal Aviation Regulations (14 CFR 21.197 and 21.199) to operate the airplane to a location where the requirements of this AD can be accomplished.

Issued in Renton, Washington, on October 13, 1994

Darrell M. Pederson,

Acting Manager, Transport Airplane Directorate, Aircraft Certification Service.

[FR Doc. 94–25845 Filed 10–18–94; 8:45 am]

BILLING CODE 4910–13–U

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release Nos. 33–7101; 34–34831; 35–26141; 39–2324; IC–20619) File No. S7–29–94]

Safe Harbor for Forward-Looking Statements

AGENCY: Securities and Exchange Commission.

ACTION: Concept Release and Notice of Hearing.

SUMMARY: The Securities and Exchange Commission ("Commission") is soliciting comment on current practices relating to disclosure of forward-looking information. In particular, the Commission seeks comment on whether the safe harbor provisions for forward-looking statements (set forth in Rule 175 under the Securities Act of 1933 ("Securities Act"), Rule 3b–6 under the Securities Exchange Act of 1934 ("Exchange Act"), Rule 103A under the Public Utility Holding Company Act of 1935 and Rule 0–11 under the Trust Indenture Act of 1939) are effective in encouraging disclosure of voluntary forward-looking information and protecting investors or, if not, should be revised and if revised, how. The Commission also seeks comment on various changes to the existing safe harbor provisions that have been suggested by certain commentators. Finally, the Commission is announcing that public hearings will be held beginning February 13, 1995, to consider these issues.

DATES: Comments should be received on or before January 11, 1995. Public hearings will begin at 10:00 a.m. on February 13, 1995. Those who wish to testify at the hearings must notify the Commission in writing of their intention to appear on or before December 31, 1994. The written notification should include a brief summary of the proposed testimony. Those who do not wish to appear at the hearings may submit written testimony on or before January 11, 1995 for inclusion in the hearing record. The schedule of appearances, date for submission of final written testimony by persons who will appear, and an agenda for the hearings will be announced by the Commission shortly before the hearings commence.

ADDRESSES: Persons wishing to submit notice of an intent to appear at the hearings, written comments or testimony should file three copies thereof with Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. All written notice, comments and testimony should refer to File No. S7–9–4. All written material will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549.

FOR FURTHER INFORMATION CONTACT: Kevin C. Bruce or Andrew A. Gerber, Attorney-Advisers in the Division of Corporation Finance or Amy Bowerman Freed, Deputy Chief Counsel, Division of Corporation Finance at (202) 942–2900.

SUPPLEMENTARY INFORMATION:

I. Introduction

Forward-looking information [1] occupies a vital role in the United States securities markets. Investors typically consider management's forward-looking information important and useful in evaluating a company's economic prospects and consequently in making their investment decisions.[2] Analysts and other market participants report that they view consideration of management's own performance projections, *i.e.*, earnings and revenues, to be critical to their own forecasts of a company's future performance. As such, forward-looking information is often considered a critical component of investment recommendations made by broker-dealers, investment advisers and other securities professionals.[3]

A. Development of Safe Harbor

1. Wheat Commission

Until the early 1970s, the Commission prohibited disclosure of forward-looking information.[4] This policy was based primarily on the Commission's perception that such information was inherently unreliable, and that unsophisticated investors would place

[1] The term "forward-looking statement" is defined in current Rule 175 as limited to the following: (1) A statement containing a projection of revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure or other financial items; (2) A statement of management's plans and objectives for future operations; (3) A statement of future economic performance contained in management's discussion and analysis of financial condition and results of operations included pursuant to Item 303 of Regulation S–K or Item 9 of Form 20–F; or (4) Disclosed statements of the assumptions underlying or relating to any of the statements described in (1), (2), or (3) above. 17 CFR 230.175.

[2] Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission, *Report to the House Committee on Interstate and Foreign Commerce, 95th Cong., 1st Session,* (Committee Print 1977) [hereinafter the "Advisory Committee Report"]; Securities Act Release No. 6084 (Jun. 25, 1979); *see also* H. Pitt and K. Groskaufmanis, *Securities Law,* Nat. L. J. (Aug. 22, 1994) at B4.

[3] *Advisory Committee Report, supra* note 2, at 351.

[4] Securities Act Release No. 5362 (Feb. 2, 1973).

undue emphasis on the information in making investment decisions.[5]

Acting on the recommendation of a number of securities analysts,[6] the Commission formed a Disclosure Policy Group (the "Wheat Commission") to study a variety of disclosure issues, including whether projections should be permitted or mandated in Commission filings.

While the Wheat Commission's Report to the Commission, published in 1969, recognized that most investment decisions are based essentially on estimates of future earnings, the Commission determined that the detriments to investors associated with permitting forward-looking disclosure weighed against lifting the ban on disclosure of such information. In the Wheat Commission's view, the heightened litigation exposure, updating requirements and risk of undue investor reliance on this information outweighed any countervailing benefits.[7]

2. Rulemaking Initiatives

The Commission continued to consider these issues and conducted hearings in 1972 to determine whether to lift the ban and, instead, either mandate or permit disclosure of forward-looking information. The 1972 hearings involved fifty-three witnesses and resulted in the submission of over 200 letters of comment. A significant number of those letters were from issuers objecting to any suggestion that they be required to file forward-looking statements with the Commission. Following those hearings, the Commission elected in 1973 not to require disclosure of forward-looking information, but announced in a policy statement its intention to promulgate rules to permit voluntary disclosure of projections and to protect those projections from civil antifraud liability.[8]

In 1975, the Commission issued a series of proposals designed to implement the 1973 policy statement.[9] Specifically, the proposals would have:

1. Required the filing of a Form 8–K by any registrant that (a) had furnished a projection to any person, (b) had reason to believe that its public projections no longer had a reasonable basis, (c) had determined to cease issuing projections, or (d) wished to disassociate itself from a third person's projections;

2. Amended Form 10–K to (a) require inclusion therein of all prior projections, together with actual and historical results; (b) require inclusion of projections for future periods that had been previously filed with the Commission; and (c) limit the filing of projections to those issuers with Exchange Act reporting histories and budgeting experience and to those projections that satisfied the requirements of proposed safe harbor Rules 132 (a proposed predecessor of Rule 175) and 3b–6;

3. Created new Rules 132 and 3b–6, providing a safe harbor "by defining circumstances under which a projection would be deemed not to be an untrue or misleading statement of a material fact or a manipulative, deceptive, or fraudulent device, contrivance, act or practice as those terms are used in the various liability provisions of the federal securities laws"; and

4. Required that all projection information contained in the text of Form 10–K (but not exhibits) be included in the registrant's annual report to shareholders.[10]

In 1976, these proposed rules were withdrawn by the Commission in response to opposition from commenters.[11] In withdrawing the proposals, the Commission stated its hope that forward-looking information and the need for a safe harbor would be among those issues considered by the newly formed Advisory Committee on Corporate Disclosure.[12]

3. Advisory Committee Report

The Advisory Committee on Corporate Disclosure was formed in 1976 to evaluate certain of the Division of Corporation Finance's disclosure policies—among them the Division's policy on disclosure of forward-looking information.[13] On November 3, 1977, the Advisory Committee submitted its report to the Commission.[14]

In the course of its deliberations, the Advisory Committee had sought input from all interested persons on the costs and benefits of forward-looking information.[15] The Advisory Committee recommended in its report that the Commission act to encourage forward-looking disclosures, and made several specific recommendations regarding the form and substance of proposed Commission action.

First, in recognition that the Commission needed experience with projections disclosure in order to evaluate the wisdom of establishing a regulatory framework for such disclosure, the Committee stated that its recommendations were intended to encourage projections on an experimental basis. Such voluntary disclosure would enable the Commission to assess both the usefulness of the information to investors, and the costs to issuers of providing that information.[16] If forward-looking information disclosures ultimately were found to be beneficial to investors, the Committee believed that market forces, rather than a Commission mandate, would operate effectively to compel issuers to make such disclosures.[17]

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[5] *Disclosure to Investors: A Reappraisal of Administrative Policies Under the 1933 and 1934 Acts* (1969) at 94 [hereinafter the "Wheat Report"].

[6] Security analysts had suggested that the Commission permit "controlled" projections of sales and earnings in prospectuses and other documents filed with the Commission. *Wheat Report, supra* note 5, at 95–96.

[7] The Wheat Report stated these findings as follows: From a management standpoint, projections may change rapidly during a given year as changes occur in the factors on which they are based. Inclusion of such changing projections in a prospectus, which might be used long after it became effective would give rise to significant problems. It has been the Commission's long-standing policy not to permit projections and predictions in prospectuses and reports filed with the Commission. Such documents are designed to elicit material facts. Their factual character is widely recognized. Investors and their advisers are at liberty to make their own projections based on the disclosures resulting from the Commission's requirements. A real danger exists, in the Study's judgment, that projections appearing in prospectuses and other documents filed under securities laws and reviewed by the Commission would be accorded a greater measure of validity by the unsophisticated than they would deserve. *Wheat Report, supra* note 5, at 95–96.

[8] Securities Act Release No. 5362 (Feb. 2, 1973) ("[t]he Commission has never required a company to publicly disclose its projections and does not intend to do so now"). The Commission stated that its decision not to mandate disclosure of forward-looking statements was based on its desire not to deviate too far from its historical position of prohibiting such disclosure. *Id.*

[9] *See* Securities Act Release No. 5581 (April 28, 1975).

[10] *See id.*

[11] *See* Securities Act Release No. 5699 (Apr. 23, 1976).

[12] *See id.* At the same time, the Commission expressed initial approval of new Division of Corporation Finance guides designed to encourage the inclusion of projections in Commission filings. These guides called for: (1) A good faith assessment of the reliability of the projection; (2) a reasonable basis for that assessment; (3) outside review of the projections; (4) the use of reasonable ranges; (5) the use of a reasonable period of projection; (6) the inclusion of assumptions on which the projection is based; (7) the inclusion of cautionary language; and (8) disclosure of the accuracy of the issuer's prior projections. The Commission authorized issuance of substantially similar final guides in Securities Act Release No. 5992 (Nov. 7, 1978).

[13] *See* Exchange Act Release No. 12454 (May 18, 1976).

[14] Advisory Committee Report, *supra* note 2.

[15] *Id.; see also* Exchange Act Release No. 12454 (May 18, 1976) (noting public meetings held by the Advisory Committee and case studies to be conducted by the Advisory Committee of thirty public companies, financial analysts and investment decision makers).

[16] Advisory Committee Report, *supra* note 2, at 353.

[17] *Id.* at 354.

Second, the Committee recommended that the Commission adopt a safe harbor that would protect forward-looking statements made in good faith and with a reasonable basis, regardless of whether those statements were included in documents filed with the Commission. The Committee recommended that the burden be placed on the person seeking to establish antifraud liability for the forward-looking statement to show a lack of good faith or reasonable basis.[18]

Third, the Committee opined that a safe harbor should be available to all registrants, regardless of size and reporting history. It also recommended that companies be required to publish cautionary language along with the projection, to indicate clearly the nature of the projection and caution investors against ascribing undue weight thereto.[19] The Committee believed that disclosure of assumptions should be encouraged, but not required.[20] Further, the Committee concluded that companies should be encouraged, but not required, to compare actual results with earlier projections and to explain any significant variance.

While the Committee recommended that companies be reminded of their obligations to keep a published projection from becoming misleading in light of subsequent events, it urged that no formal requirement to update projections be imposed. In the Committee's view, companies should be permitted either to discontinue making projections or to resume such projections after discontinuation, but should not do so without a reasonable basis.

The Committee had a different view of mandatory disclosure and updating in connection with forward-looking information disseminated during the Securities Act registration process. Specifically, the Committee expressed its opinion that "the Commission should require companies to include such current projections covering the current period in their registration statements (updated as necessary) filed under the Securities Act."[21]

With respect to the type of information that should be disclosed, the Committee believed that companies should have the flexibility to choose which items to disclose, but should not be permitted to disclose only "favorable" items. Finally, the Committee recommended that the Commission permit third-party review of projections, provided that the third-party reviewer's credentials, extent of review, and relationship with the issuer were disclosed.[22]

4. Adoption of Safe Harbor Provision

In response to the Advisory Committee Report, the Commission announced in early 1978 that the Committee's recommended safe harbor rule would receive formal Commission consideration, along with any alternatives the Commission deemed appropriate.[23] Later that year, the Commission issued for public comment two versions of a safe harbor rule for forward-looking information: the Advisory Committee version, in the same form as the Committee had proposed, and another version formulated by the Commission.[24]

As set forth in the Commission's proposing release, the differences between the two proposals, as well as the questions asked and comments requested, reflected the Commission's reservations with respect to certain aspects of the Advisory Committee proposal. First, the Commission was particularly concerned that the burden of proving a lack of reasonable basis, which the Committee recommended be imposed on the plaintiff, "could be insurmountable."[25] The Commission therefore proposed an alternative rule that would have placed the burden on the defendant to prove that a challenged projection was made in good faith and with a reasonable basis.

There were several other substantive differences between the two proposals. Unlike the Advisory Committee's proposal, the Commission's alternative extended to third-party projections, while concomitantly restricting safe harbor protection to financial projections and similar statements, limiting safe harbor protection to statements made about reporting companies, and excluding statements about investment companies. Significantly, both proposed safe harbor rules covered all oral and written forward-looking information, not just when contained in Commission filings. Neither proposal specifically required inclusion of current projections in registration statements filed under the Securities Act, and no mention was made in the release of the reasons for this omission.

In response to the proposals, the Commission received approximately 90 letters of comment. A majority of commenters expressed a belief that a rule incorporating aspects of both proposals would provide the best incentive for projection disclosure.[26] Although a few commenters expressed continuing reservations about the Commission's proposed shift in policy from prohibiting to encouraging projection disclosure, virtually all agreed that a safe harbor rule was desirable and necessary.[27] Most commenters agreed that the safe harbor should be extended to statements made on behalf of the issuer (*i.e.*, by third party reviewers).

Several commenters criticized other aspects of the Commission's alternative proposal, arguing that the burden of proof for establishing that a projection did not have a reasonable basis or was not made in good faith should be imposed on the plaintiff,[28] and that the rule's coverage should be extended beyond revenues, earnings, and "other financial items" to encompass management's plans and objectives.[29] Commenters argued that the rule's protections should not be limited to companies with a reporting history.[30] Commenters concurred in the proposal to forego conditioning the rule's availability on inclusion of the information in Commission filings on the ground that such a condition could result in a loss of the safe harbor's protections based on a technical or inadvertent filing delinquency. Comments on the propriety of projections by investment companies were mixed.[31]

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[18] *Id.* at 344.

[19] *See id.*

[20] Although the Committee recognized the value of assumptions, it opted against requiring disclosure of assumptions for two reasons: (a) because of the experimental nature of the program, the Committee apparently concluded that fewer mandatory disclosure items were appropriate; and (b) in order to encourage as many issuers to use the safe harbor rule as possible, the Committee wanted to keep the rule simple and thus facilitate compliance. *Id.*

[21] *Id.* at 361.

[22] The Committee believed that any such reviewer should be deemed an expert and should file an appropriate consent with the registration statement. *Id.*

[23] Securities Act Release No. 5906 (Feb. 15, 1978).

[24] *See* Securities Act Release No. 5993 (Nov. 7, 1978).

[25] *Id.*

[26] Securities Act Release No. 6084 (Jun. 25, 1979).

[27] *Id.*

[28] *Id.* Placing the burden on corporate defendants to prove that a projection was prepared with a reasonable basis and disclosed in good faith was viewed as undermining the Commission's goal of encouraging projection disclosure, and possibly worse than no rule at all.

[29] *Id.*

[30] *Id.* According to the release, commenters argued that "forecast information may be most valuable regarding companies that do not have a history of public information." *Id.*

[31] *Id.* As the Commission observed, "some commenters did not perceive a basis for distinguishing between investment companies and other issuers . . . . Other commenters believed that the type of information generated by investment companies would be more difficult to forecast with reliability and is dependent upon market factors and responses to market events that are inherently unpredictable."

In 1979, the Commission adopted a safe harbor provision that generally combined aspects of both proposals.[32] Virtually identical safe harbor provisions were codified in Rule 175 under the Securities Act and Rule 3b–6 under the Exchange Act.[33] These provisions offered safe harbor protection for specified forward-looking statements but only where made, reaffirmed, or later published, in documents filed with the Commission. On this point, the Commission stated that this "filing" requirement would provide investors with better access to the information and a more reliable framework within which to evaluate the forward-looking statement, and would enable the Commission to maintain oversight of the accuracy and completeness of the disclosure.

Second, the final rule incorporated the Advisory Committee's recommendation of placing the burden of proof on the plaintiff to show that the forward-looking information lacked a reasonable basis and was made otherwise than in good faith. The Commission reasoned that the liberal discovery procedures available in the federal courts had permitted plaintiffs to elicit the evidence necessary to sustain this burden. The Commission stated that it would monitor the operation of the safe harbor rule to assure that it was not inconsistent with the pre-eminent statutory goal of investor protection.[34]

The safe harbor provision, as adopted, did not require the publication of assumptions underlying forward-looking statements covered by the rule. In describing the basis for this decision, the Commission "re-emphasize[d] its position on the significance of assumption disclosures," explaining that:

> Under certain circumstances the disclosure of underlying assumptions may be material to an understanding of the projected results. The Commission also believes that the key assumptions underlying a forward-looking statement are of such significance that their disclosure may be necessary in order for such statements to meet the reasonable basis and good faith standards embodied in the rule. Because of the potential importance of assumptions to investor understanding and in order to encourage their disclosure, the rule as adopted indicates specifically that disclosed assumptions are also within its scope.[35]

The Commission made explicit the availability of the safe harbor to third-party reviewers, both those retained by the company and those making projections on behalf of management. Also, while not adding any requirement to update projections, the Commission reiterated its earlier position that projections protected by the safe harbor must be corrected when subsequent events or discoveries render them false or misleading.

Finally, the Commission elected not to extend coverage of the rule to investment companies registered under the Investment Company Act of 1940. While not rejecting the possibility that projections could be valuable to shareholders of registered investment companies, the Commission stated that "the nature of information reported by investment companies is sufficiently distinct to warrant separate consideration."[36]

The safe harbor provision has retained its essential elements, although the Commission has made several technical modifications since its adoption.[37]

B. Management's Discussion and Analysis Interpretative Release

Since 1979, the Commission has further refined its position on disclosure of forward-looking information, particularly in the context of developing and interpreting the management's discussion and analysis ("MD&A") requirements applicable to the Form 10–K and other required filings, as codified in Regulation S–K Item 303.[38] These contain a number of provisions that call for disclosure of prospective information.[39] An instruction to Item 303(a) states that the MD&A "shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of [the] future * * *."[40] In contrast to this required disclosure of "presently known data which will impact upon future operating results," registrants are expressly encouraged, but not required, to supply forward-looking information.[41] The Commission clarified the distinction between "voluntary" and "mandatory" forward-looking disclosure in a 1989 interpretative release relating to MD&A:

> Both required disclosure regarding the future impact of presently known trends, events or uncertainties and optional forward-looking information may involve some prediction or projection. The distinction between the two rests with the nature of the prediction required. Required disclosure is based on currently known trends, events, and uncertainties that are reasonably expected to have material effects, such as: a reduction in the registrant's product prices; erosion in the registrant's market share; changes in insurance coverage; or the likely non-renewal of a material contract. In contrast, optional forward-looking disclosure involves anticipating a future trend or event or anticipating a less predictable impact of a known event, trend or uncertainty.[42]

Thus, the Commission has distinguished between mandatory and voluntary forward-looking statements for disclosure purposes. Moreover, in the context of transactions involving an issuer's or affiliate's purchase of the issuer's shares, or a business combination, forward-looking information (including projections) may be required pursuant to Rule 10b–5.[43]

C. Qualitative Performance

There appears to be increasing interest, on the part of both registrants and users of their financial reports in the investor and analyst communities, in enhanced disclosure of information that may affect corporate performance but is not readily susceptible of measurement in traditional, quantitative terms.[44] Among such qualitative informational items are workforce training and development, product and

[32] *See* Securities Act Release No. 6084 (Jun. 25, 1979).

[33] 17 CFR 230.175 (1994), 17 CFR 240.3b–6 (1994).

[34] *Id.*

[35] *Id.*

[36] *Id.* The Commission decided not to require that investment companies provide forward-looking disclosure under the recently-adopted "management's discussion of performance" requirement for registered open-end investment companies. Securities Act Release No. 6988 (Apr. 6, 1993).

[37] *See* Securities Act Release No. 6949 (Jul. 30, 1992); Securities Act Release No. 6353 (Mar. 3, 1982); Securities Act Release No. 6304 (Mar. 27, 1981); Securities Act Release No. 6291 (Feb. 17, 1981); and Securities Act Release No. 6288 (Feb. 9, 1981).

[38] Regulation S–K Item 303, 17 CFR 238.303 (1994).

[39] With respect to liquidity, disclosure is required of "any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in * * *" material changes. *See* Regulation S–K Item 303(a)(1), 17 CFR 229.303(a)(1) (1994). With respect to capital resources, the disclosure calls for "any known material trends, favorable or unfavorable * * *" Regulation S–K Item 303(a)(2)(ii), 17 CFR 229.303(a)(2)(ii) (1994). With respect to sales, revenue or income, the Item calls for "any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact * * *" Regulation S–K Item 303(a)(3)(ii), 17 CFR 229.303(a)(3)(ii).

[40] *See* Regulation S–K Item 303, Instruction 3, 17 CFR 229.303 (1994).

[41] *See* Regulation S–K, Item 303, Instruction 7, 17 CFR 229.303 (1994).

[42] Securities Act Release No. 6835 (May 18, 1989).

[43] Projections might also be contained in documents required to be filed and discussed pursuant to specific line item requirements. *See* Item 4(b) of Form S–4; 17 CFR 239.25; Item 9 of Schedule 13E–3; 17 CFR 240.13e.100

[44] *See* R. Eccles and S. Mavrinac, *Improving the Corporate Disclosure Process* (Harvard Business School Working Paper 94–061 (1994) (hereinafter "Eccles & Mavrinac"); Stewart, *Your Company's Most Valuable Asset: Intellectual Capital*, Fortune, October 3, 1994 at 68 (hereinafter "Stewart").

process quality and customer satisfaction. A large registrant considers one such item—product quality—to be so important to its profitability that it has chosen to make it a key determinant of executive compensation.[45] Other companies are beginning to experiment with voluntary disclosure of the utilization of an intangible asset termed "intellectual capital," or employee knowledge.[46] In this connection, another federal agency has urged more corporate disclosure of the use of measures of "high performance work practices and other nontraditional measures" of corporate performance.[47]

With respect to the interest of users in this type of "soft," or nonquantitative, corporate information, a large public pension fund factors labor-management relations and other aspects of human resource management into analyses of portfolio company performance in connection with the fund's investment and voting decisions, based on research indicating that workplace practices can be linked to corporate performance. [48] Private pension fund fiduciaries are likely to follow this example, given the Department of Labor's recent issuance of an interpretive bulletin urging such fiduciaries to monitor more closely portfolio companies' investment in training and otherwise developing their workforce.[49]

Notwithstanding this growing market interest in access to qualitative performance information, registrants have expressed significant concern that disclosure of such information may expose them to greater litigation risk.[50] To the extent that this type of "soft" information does not fall within the current safe harbor definition of "forward-looking statements," however, it would not receive the protection of Rule 175 or 3b–6.

II. Judicial Approaches Toward Liability for Forward-Looking Statements

Contemporaneously with the evolution of the Commission's policy on disclosure of forward-looking information, the federal courts have adopted a variety of approaches toward private antifraud claims arising from such disclosures.[51]

A. Untrue Statement of Fact

The courts first addressed the question of whether predictions or statements of opinion could ever be considered to be "facts" which could be said to be false or misleading for purposes of liability under the securities laws. In *Marx* v. *Computer Sciences Corporation*,[52] the court found that while predictions could properly be characterized as facts, the failure of a prediction to prove true was not in itself actionable. Instead, the court looked at the factual representations which it found were impliedly made in connection with the prediction; namely that, at the time the prediction was made, it was believed by its proponent and it had a valid basis.[53] If a prediction was not believed when made or did not have a valid basis, it would constitute an untrue statement of fact which could then be analyzed in accordance with the other necessary elements of the action:[54] *i.e.*, materiality, reliance, scienter, and causation.

B. Materiality and Reliance

Some courts have disposed of cases involving forward-looking statements without reaching the issue of these implied factual assertions by examining another element of the claim—materiality or, as described in some cases, reliance. Most of these cases have been decided on the basis of the "bespeaks caution" doctrine,[55] which has been described as follows:

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[45] *See* Chrysler Corporation, 1994 Proxy Statement, filed March 16, 1994.

[46] *See Stewart, supra* note 44; (*citing* Skandia AFS' 1994 Annual Report to Shareholders). *See also* 1994 Annual Reports to Shareholders submitted to the Commission by Dow Chemical Corporation and National Steel Company.

[47] Letter from Secretary Robert B. Reich to Chairman Arthur Levitt (Oct. 3, 1994).

[48] *See IRRC Corporate Governance Highlights*, (July/August 1994) at 15–16 (reporting that the California Public Employees' Retirement System, the nation's largest public pension fund, announced that it will consider workplace practices along with financial performance criteria in connection with the fund's annual corporate governance review of portfolio companies, based on the positive correlation found by economist Lilli A. Gordon between "high-performance workplace practices" and enhanced productivity and long-term financial performance of such companies).

[49] Department of Labor Interpretive Bulletin 94–2; 59 FR 38860 (July 29, 1994).

[50] *See, e.g.*, Letter from Frank J. Borelli, Treasurer, Financial Executives Institute to Edmund L. Jenkins, Chairman, AICPA Special Committee on Financial Reporting, dated Aug. 8, 1994 (objecting to Jenkins Committee proposals for expanded disclosure of additional forward-looking and qualitative performance information due in part to litigation exposure). *See also Eccles & Mavrinac, supra* note 44; *Stewart, supra* note 44. The Conference Board has established a working group headed by Dr. Carolyn Brancato and comprised of U.S and foreign companies, institutional investors, analysts, and U.S. regulators. Charged with developing a systemic approach to disclosure of corporate performance, both on a financial and non-financial basis, by the spring of 1995, the Group is exploring ways of: (a) Encouraging companies to report their use of qualitative performance criteria despite the perceived litigation risk; and (b) educating institutional investors, analysts and others as to the utility of such information and its relationship to such quantitatively measured indicia of corporate performance as earnings.

[51] The safe harbor provided by Rules 175 and 3b–6 has been implicated in only a small portion of cases involving forward-looking statements. *See Arazi* v. *Mullane*, 2 F.3d 1456 (7th Cir. 1993); *Krim* v. *BancTexas Group, Inc.*, 989 F.2d 1435 (5th Cir. 1993); *Roots Partnership* v. *Lands' End, Inc.*, 965 F.2d 1411 (7th Cir. 1992); *Wielgos* v. *Commonwealth Edison Co.*, 892 F.2d 509 (7th Cir. 1989).

[52] 507 F.2d 485 (9th Cir. 1974).

[53] *Id.* at 489–90 ("[T]he forecast may be regarded as a representation that * * * [the issuer's] informed and reasonable belief was that at the end of the coming period, earnings would be approximately $1.00. * * * In addition, because such a statement implies a reasonable method of preparation and a valid basis, we believe also that it would be 'untrue' absent such preparation or basis."). Many courts have adopted similar formulations. *See In re Apple Computer Securities Litigation*, 886 F.2d 1109, 1113 (9th Cir. 1989) ("A projection or statement of belief contains at least three implicit factual assertions: (1) that the statement is genuinely believed, (2) that there is a reasonable basis for that belief, and (3) that the speaker is not aware of any undisclosed facts tending to seriously undermine the accuracy of the statement. A projection or statement of belief may be actionable to the extent that one of these implied factual assertions is inaccurate." (citing *Marx*)); *Isquith* v. *Middle South Utilities, Inc.*, 847 F.2d 186, 203–04 (5th Cir. 1988) ("Most often, whether liability is imposed depends on whether the predictive statement was 'false' when it was made. The answer to this inquiry, however, does not turn on whether the prediction in fact proved to be wrong; instead, falsity is determined by examining the nature of the prediction—with the emphasis on whether the prediction suggested reliability, bespoke caution, was made in good faith, or had a sound factual or historical basis." (footnote omitted)); *Kirby* v. *Cullinet Software, Inc.*, 721 F.Supp. 1444, 1450 (D.Mass. 1989) ("At a minimum, a prediction must be made in good faith and with a sound historical or factual basis.").

Rule 175 and Rule 3b–6 follow a similar path by providing that a covered statement shall not be deemed to be, *inter alia*, an untrue statement of a material fact, unless it is shown that such statement was made or reaffirmed without a reasonable basis or was disclosed other than in good faith. Although the Rules use the term "fraudulent statement" to refer to such an untrue statement of a material fact, a separate determination must be made as to whether the statement, though untrue, is fraudulent or otherwise actionable under the securities laws. In *Wielgos* v. *Commonwealth Edison Co., supra* at 513, the court considered the use of the term "fraudulent statement" in the Rules, but easily determined that Rule 175 applies to actions under § 11 of the Securities Act even though liability under that section does not depend on "fraud."

[54] *Id.* at 490. In the recent case of *Rubinstein* v. *Collins*, 20 F.3d 160, 169 (5th Cir. 1994), the court stated this point succinctly: Simply alleging that the predictive statements at issue here did not have a reasonable basis—that is, that they were negligently made—would hardly suffice to state a claim under Rule 10b–5. As we have consistently held, scienter is an element of such a claim. * * * Plaintiffs have satisfied the pleading requirements for scienter. They have claimed that the defendants either knew—or were recklessly indifferent to—the fact that the predictive statements did not have a reasonable basis. (Footnotes omitted.)

[55] Seven circuit courts have applied the bespeaks caution doctrine in analyzing forward-looking statements (although the Sixth Circuit, after applying the doctrine in one case, stepped back somewhat in a subsequent decision). *See In re Worlds of Wonder Sec. Litig.*,—F.3d —, 1994 WL 501261 (9th Cir. 1994); *Rubinstein* v. *Collins*, 20 F.3d 160 (5th Cir. 1994); *In re Donald J. Trump Casino Sec. litig.*, 7 F.3d 357 (3d Cir. 1993); *Luce*

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The essence of the doctrine is that where an offering statement, such as a prospectus, accompanies statements of its future forecasts, projections and expectations with adequate cautionary language, those statements are not actionable as securities fraud.[56]

Under the bespeaks caution doctrine, cautionary language, as a part of the "total mix" of information, may render a predictive statement immaterial as a matter of law,[57] or make it unreasonable for an investor to rely upon a predictive statement.[58] Recently, some courts have warned, however, that cautionary language, in and of itself, is not necessarily sufficient.[59] "To suffice, the cautionary statements must be substantive and tailored to the specific future projections, estimates or opinions in the prospectus which the plaintiffs challenge."[60]

Some courts have taken a more extreme position, determining that, even without cautionary language, some predictions are not material. For example, referring to "soft," "puffing" statements, upon which no reasonable investor would rely, the Court of Appeals for the Fourth Circuit stated that, "projections of future performance not worded as guarantees are generally not actionable under the federal securities laws."[61]

III. Criticisms of the Commission's Safe Harbor

Some have suggested that companies that make voluntary disclosure of forward-looking information subject themselves to a significantly increased risk of securities antifraud class actions.[62] Recent surveys suggest that this threat of mass shareholder litigation, whether real or perceived, has had a chilling effect on disclosure of forward-looking information.[63]

Contrary to the Commission's original intent, the safe harbor is currently invoked on a very limited basis in a litigation context.[64] Some critics of the current safe harbor provisions cite, among other things, the following as weaknesses of the safe harbor:

—the protections of the safe harbor are too narrow because they are limited to filed documents, resulting in selective disclosure made outside Commission documents;[65]

—the provisions of the safe harbor are not applied by the courts in a manner that results in quick and inexpensive dismissals of frivolous lawsuits;[66]

—there is a great deal of confusion over the nature and scope of any duty to correct or update projections once they are made;[67] and

—the safe harbor language is silent as to when a company may be liable for statements made by third parties.

A. Suggested Underinclusiveness of Current Safe Harbor

Some critics argue that the current safe harbor is ineffective largely because it is too narrow, in that it only covers statements made in documents filed with the Commission.[68] They contend that, due to this underinclusiveness, the safe harbor provides no comfort in most situations involving disclosure of forward-looking information. While acknowledging concern that the problem of selective disclosure prompted the Commission to adopt such a limitation in 1979,[69] these critics contend that this very limitation has created the unintended by-product of fostering such selective disclosure.

Many public companies complain that they face increasing analyst and institutional demands for immediate access to predictive information. Some issuers argue that, solely to gain the benefits of the safe harbor through reaffirmation of oral responses to recurring marketplace inquiries in Commission documents, they would be put to the impossible task of memorializing every analyst discussion. Given the informal and often unpredictable nature of communications between issuers and analysts, the provision in the safe harbor requiring Commission filing of forward-looking information is viewed as both counterproductive and highly impractical.

B. Judicial Application

Another complaint commonly raised is that the provisions of the existing safe harbor do not influence the standards that courts apply in securities fraud cases. The safe harbor is infrequently raised by defendants, perhaps because it compels judicial examination of reasonableness and good faith, which raise factual issues that often preclude early, prediscovery dismissal. Thus, critics state that the safe harbor is ineffective in ensuring the quick and inexpensive dismissal of frivolous private lawsuits. These critics argue that, unless the courts vigorously apply a higher pleading threshold sufficient to sustain a motion to dismiss based on the allegations of a class-action complaint, the mere threat of litigation will continue both to discourage management from making forward-looking disclosure and cause those companies that nonetheless provide such disclosure to incur significant costs in defense of nonmeritorious litigation. Those urging reform thus maintain that, in order for a safe harbor effectively to encourage forward-looking

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v. *Edelstein*, 802 F.2d 49 (2d Cir. 1986); *Romani* v. *Shearson Lehman Hutton*, 929 F.2d 875 (1st Cir. 1991); *Moorhead* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 949 F.2d 243 (8th Cir. 1991). The Sixth Circuit adopted the doctrine in *Sinay* v. *Lamson & Sessions Co.*, 948 F.2d 1037 (6th Cir. 1991), but revised its application of the doctrine in *Mayer* v. *Mylod*, 988 F.2d 635 (6th Cir. 1993). *See generally* Donald C. Langevoort, *Disclosures that "Bespeak Caution,"* 49 Bus. Law. 481 (February 1994).

[56] *In re Donald J. Trump Casino Sec. Litig.*, 793 F.Supp. 543, 549 (D.N.J. 1992), *aff'd*, 7 F.3d 357 (3d Cir. 1993).

[57] *See In re Donald J. Trump Sec. Litig.*, *supra* at 371 ("[C]autionary language, if sufficient, renders the alleged omissions or misrepresentations immaterial as a matter of law."); *In re Worlds of Wonder Sec. Litig.*, *supra*; *Rubinstein v. Collins*, *supra*.

[58] *Rubinstein* v. *Collins*, *supra* at 167 (cautionary language affects "the reasonableness of the reliance on and the materiality of [the] projections." (footnotes omitted)).

[59] *See Rubinstein* v. *Collins*, *supra* at 167–68; *In re Donald J. Trump Casino Sec. Litig.*, *supra* at 371–72.

[60] *In re Donald J. Trump Casino Sec. Litig.*, *supra* at 371–72.

[61] *Raab* v. *General Physics Corp.*, 4 F.3d 286, 290 (4th Cir. 1993) (quoting *Krim v. BancTexas Group, Inc.*, 989 F.2d 1435, 1446 (5th Cir. 1993)). In *Malone* v. *Microdyne Corp.*, 26 F.3d 471, 479–0 (4th Cir. 1994), the Court of Appeals relied on *Raab* in finding that a forward-looking statement was not actionable because the "statement obviously did not constitute a guarantee and was certainly not specific enough to perpetrate a fraud on the market."

[62] U. Gupta & B. Bowers, *Small Fast-Growth Firms Feel Chill of Shareholder Suits*, Wall St. J., April 5, 1994 at B2. *See generally* Staff Sen. Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs, *Report on Private Securities Litigation*, (1994) ("Senate Staff Report").

[63] National Venture Capital Association, *The Impact of Securities Fraud Suits on Entrepreneurial Companies* (Jan. 1994); National Investors Relations Institute, *Corporate Survey on Shareholder Litigation Effects* (Feb. 1994); American Stock Exchange CEO Survey, *Securities Litigation and Stock Option Accounting* 1 (Apr. 1994).

[64] *See* Louis Loss and Joel Seligman, Securities Regulation, 622–39 (1992); Barondes, *The Bespeaks Caution Doctrine: Revisiting the Application of Federal Securities Law to Opinions and Estimates*, J.Corp. L. 243, 247 (1994).

[65] *See* American Stock Exchange Survey, *CEOs Would Release More Financial Information If Litigation Albatross Were Removed* (1994); *See generally* S. Marino and R. Marino, *An Empirical Study of Recent Securities Class Action Settlements Involving Accountants, Attorneys, or Underwriters*, Sec. Reg. L. J. (1994) at 115; V. O'Brien and R. Hodges, *A Study of Class Action Securities Fraud Cases 1988–1993* (working draft 1994); J. Macey and G. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. Chicago L. Rev. 1 (1991).

[66] Senate Staff Report, *supra* note 62.

[67] Manns, *Duty to Correct: A Suggested Framework*, 46 Md. L. Rev. 1250 (1987).

[68] *See, e.g.*, M. Seeley, *In I.P.O.'s, the More Data the Better*, New York Times Forum, April 26, 1992. The majority of litigated cases appear to arise out of non-filed forward-looking statements further undercutting the utility of the safe harbor.

[69] *See* Advisory Committee Report, *supra* note 2.

disclosure, it must add protection over and above those afforded by judicial doctrines developed under what are characterized as the "housekeeping" provisions of the Federal Rules of Civil Procedure—Rules 9(b) and 12(b)(6).[70]

A related criticism is that courts are inconsistent in applying the safe harbor when it is implicated in the litigation. The courts do not always refer to the safe harbor when it is implicated.[71] One court refused to permit the use of the safe harbor because the earnings forecast in question had been presented "as a fact certain rather than as a 'projection' or 'forward-looking statement.'"[72] In this regard, commenters assert that the Commission should provide greater guidance to the judiciary with respect to the appropriate application of the safe harbor.

C. Duty To Correct or Update

A further criticism of the Commission's existing safe harbor is that the rule has created confusion over whether and when there is a duty to correct or update projections once they are made. A recent article suggests that issuers are often advised by their counsel to refrain from making forward-looking statements in Commission filings, or even from speaking to analysts, because they fear that by doing so they will "assume" a duty to update their forward-looking statements as and when the facts and circumstances surrounding their original statements change.[73] Furthermore, the paucity of caselaw in this area has left issuers without comfort or certainty as to when and if there is any duty to update or correct.[74] Commentators have questioned how long a forward-looking statement will be considered current and how far in the future, if at all, an issuer must continue to update.[75]

D. Entanglement and Endorsement

Another concern voiced by companies is whether to make forward-looking disclosures to securities analysts and institutional investors, whether in the context of initial public offering "roadshows" or otherwise, and the corresponding liability for any forward-looking statements included in the analysts' reports or statements. Companies complain that a better balance must be struck between the incentives and disincentives of disclosure to analysts.[76] The New York Stock Exchange, the American Stock Exchange, and the National Association of Securities Dealers encourage listed or quoted corporations to seek out formal and informal contact with analysts to facilitate the accurate pricing of their securities.[77] The Commission also encourages such communications as a complement to disclosure under the Exchange Act.[78]

The foregoing regulatory incentives must be viewed in light of potential issuer liabilities. While courts appear generally to impose no duty on a corporation to review or comment on analysts' reports, a corporation may become sufficiently entangled with the analysts' statements, by reviewing or correcting drafts of reports or otherwise, so as to assume a duty to correct or update the analyst's statements.[79] Another risk arises from selective disclosures that may be characterized as tipping.[80] As a result of these risks, frequently perceived to outweigh the benefits, some corporations have gone so far as to announce that they will not speak to analysts about future earnings projections.[81]

IV. Alternatives to Current Safe Harbor Provision

The Commission generally is examining the current effectiveness of its safe harbors as codified in Rules 175 and 3b-6. Some commentators and groups have submitted proposals to amend the safe harbor. The Commission is considering these proposals and the issues that each proposal raises, as well as its own experience in interpreting and administering the safe harbor. Where specific proposed regulatory text has been provided by these commentators or groups, that text is attached in the appendix to this release.[82]

A. "Seasoned Issuer" Proposal

The "Seasoned Issuer" Proposal, suggested by the Association of Publicly Traded Companies ("APTC"), would provide a safe harbor precluding private actions for oral and written forward-looking statements with respect to securities quoted on the NASDAQ Stock Market or listed on a national securities exchange. It would apply only to secondary trading transactions and would not modify the Commission's enforcement authority. The proposed safe harbor would be available to issuers subject to the reporting requirements of sections 13 or 15(d) of the Exchange Act that have timely filed all reports required to be filed within the six months prior to the making of the statement. The proposed safe harbor would not be available to penny stock issuers. It also excludes issuers that had been convicted of securities law violations or issuers that had been the subject of any securities related injunction within the previous five years.

The term "forward-looking statement" is defined in the proposed safe harbor

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[70] In deciding motions under Rule 12(b)(6) of the Federal Rules of Civil Procedure, at least one commentator has noted that courts apply different standards of materiality. *See* Sullivan, *Materiality of Predictive Information After Basic: A Proposed Two-Part Test of Materiality*, 1990 U. Ill. L. Rev. 207 (1990). For motions decided under Rule 9(b) of the Federal Rules of Civil Procedure, some courts have imposed a high burden on plaintiffs, requiring them to allege specific facts that give rise to an inference of fraudulent intent. *Romani* v. *Shearson Lehman Hutton*, 929 F.2d 875 (1st Cir. 1991); *see also DiLeo* v. *Ernst & Young*, 901 F.2d 624 (7th Cir. 1990). Other courts appear to have been more lenient. *In re Glenfed*, 11 F.3d 849 (9th Cir. 1993) ("plaintiff must allege facts that would give rise to an inference that the defendant did not believe the statements or knew of their falsity").

[71] The courts seldom refer to the safe harbor unless it is raised by the defendant. Examples of cases in which the safe harbor was implicated but not referenced include *Mayer* v. *Mylod*, 988 F.2d 635 (6th Cir. 1993), *Romani* v. *Shearson Lehman Hutton*, 929 F.2d 875 (1st Cir. 1991), and *In re Control Data Corp.*, 933 F.2d 616 (8th Cir. 1991).

[72] *Allyn Corp.* v. *Hartford National Corp.*, 1982 WL 1301 (D.Conn. 1982).

[73] *See* H. Pitt and K. Groskaufmanis, *Selective Disclosure can be Perilous*, Nat'l. L. J. (Apr. 18, 1994) at B4.

[74] The First Circuit has stated that the duty to update is triggered if a statement having a forward intent or implication, upon which investors are expected to rely, has been made. *Backman v. Polaroid*, 910 F.2d 17 (1st Cir. 1990) (en banc). The Ninth Circuit stated that an accurate announcement of past events did not carry with it the duty to disclose whether past trends would continue. *In re Convergent Technologies Securities Litigation*, 948 F.2d 507 (9th Cir. 1991). *See generally* Schneider, *Update on the Duty to Update: Did Polaroid Produce the Instant Movie After All?*, 23 Rev. of Sec. & Commodities Reg. 83 (May 9, 1990).

[75] *See generally*, C. Schneider, *Soft Disclosure: Thrust and Parries When Bad News Follows Optimistic Statements*, 26 Rev. Sec. & Comm. Reg. 5 (1993); R. Rosenblum, *An Issuer's Duty Under Rule 10b–5 To Correct and Update Materially Misleading Statements*, 40 Cath. Univ. L. Rev. 289 (1991).

[76] *See generally* A. Berkeley & M. Smith, *Corporate Disclosure: Potential Pitfalls*, Securities & Commodities Regulation (June 26, 1991).

[77] *See* New York Stock Exchange Manual, § 202.02; American Stock Exchange Guide § 402; and National Association of Securities Dealers Investor Relations Guide, *Cultivating the Investment Community*, at 18.

[78] Securities Act Release No. 6504 (Jan. 13, 1984).

[79] *Elkind v. Liggett & Myers*, 635 F.2d 156, 163 (2d Cir. 1980). Commentators have suggested that even a management response that an analyst's estimates are "too high," "too low" or "in the ballpark" can give rise to liability by suggesting that management bore some type of responsibility for the estimate; *see generally* Potential Pitfalls, *supra* note 76.

[80] *See Securities and Exchange Commission v. Stevens*, Lit. Rel. No. 12813 (March 19, 1991); *Elkind*, *supra*. *See generally* M. Goldman, K. Schuelke, J. Danforth and S. Thau, *Disclosures to Financial Analysts* (PLI September-October 1993).

[81] *See, e.g.*, J. Coffee, *Disclosures to Analysts are Risky*, Nat'l L.J. (Feb. 1, 1993).

[82] The transmittal letters pursuant to which some of these proposals were submitted to the Commission are included in the public file (S7–29–94).

to include any economic projection, statement of management's plans and objectives for future operations, statement of future performance and assumptions underlying the foregoing.

B. Business Judgment Rule Proposal

Commissioner Beese has proposed a safe harbor provision patterned after the state-law "business judgment rule." [83] In the pattern of that rule, the safe harbor would establish a principle of judicial non-intervention. As such, the safe harbor would protect directors and officers from judicial review of shareholder antifraud claims when forward-looking statements are made unless a plaintiff can establish a conflict, a lack of good faith, or a failure of honest and reasonable belief.

The safe harbor would cover oral or written forward-looking information, whether or not made or reaffirmed in Commission filings. Liability still could be imposed on directors or officers who make fraudulent statements, intentionally misstate facts, or fail to disclose material information when required.

To ensure that an officer or director was meeting his duties under the business judgment rule, a company would be encouraged to keep a projection binder reflecting the data underlying the projections. In the event that a private lawsuit was filed, the company would proffer the binder to the court. The burden then would shift to the plaintiffs to show why the projections lacked a proper factual basis at the time they were made. If unable to meet this burden, the case would be dismissed without any discovery.[84]

C. "Heightened Definition" Proposal

The "Heightened Definition" Proposal, put forth jointly by the Business Roundtable and the National Association of Manufacturers, would apply to all forward-looking statements and reaffirmations thereof, by or on behalf of a registrant or an outside reviewer retained by the registrant, whether or not filed with the Commission. The proposed safe harbor would apply to the same information as is protected by the current safe harbor but would expressly extend to both qualitative and quantitative statements of management's plans and objectives for future operations, including plans for the development and delivery of new products or services.

The provision would apply to all statements of reporting issuers that have timely filed their most recent annual report. As provided under the existing rule, non-reporting issuers also could rely on the safe harbor, but only if the forward-looking statement were made in a solicitation of interest document submitted under Securities Act Rule 254, in a registration statement or Regulation A Offering Circular filed under the Securities Act, or in a registration statement filed under the Exchange Act.

Liability would be imposed only if a misstatement or omission is material, made or omitted with scienter, and, for private plaintiffs, relied upon. Materiality would be defined as information that would significantly alter the total mix of information available. Scienter would be defined as actual knowledge or intentional omission to state a material fact. Reliance would be defined as actual knowledge of and actual reliance on the forward-looking statement in connection with the purchase or sale of a security. Under the proposal, there would be no attribution to the issuer of statements made by third parties unless the issuer expressly endorsed or approved of the statement. Finally, an issuer would not have a duty to update a forward-looking statement unless it expressly undertook to do so at the time the statement was made.

D. "Bespeaks Caution" Proposal

Professor John Coffee suggests a safe harbor that would codify a variant of the "Bespeaks Caution" doctrine—articulated in terms of an investor's inability to rely in an action for fraud upon statements protected by the safe harbor. Under this proposed safe harbor, which would be available to reporting companies (except penny-stock issuers), a forward-looking statement would be protected so long as it were properly qualified and accompanied by "clear and specific" cautionary language that explains in detail sufficient to inform a reasonable person of both the approximate level of risk associated with that statement and the basis therefor. Forward-looking statements made, either orally or in writing, outside the four corners of a Commission filing would be covered only if reaffirmed in a filed document or annual report made publicly available within a reasonable period after the statement is first disseminated. The suggested safe harbor would not require that the forward-looking statement have a "reasonable basis" (as under existing Rules 175 and 3b–6) because, according to Professor Coffee, this requirement often raises factual issues that cannot easily be resolved at the pre-trial stage.

Professor Coffee's approach also contemplates amendments to the incorporation-by-reference provisions of the Securities Act registration forms [85] that would exempt qualifying forward-looking statements made in Exchange Act filings from automatic incorporation by reference in Securities Act filings, and therefore from potential liability under the antifraud provisions of the Securities Act. Existing Rule 175 would remain available where registrants affirmatively seek inclusion of Exchange Act filings in Securities Act registration statements.

E. "Fraudulent Intent" Proposal

Under the "Fraudulent Intent" proposal, submitted by Mr. William Freeman, a forward-looking statement would be protected by the safe harbor unless it is shown that the statement was made recklessly or with an actual intent to deceive. In order to demonstrate that a statement was made recklessly, a plaintiff would be required to demonstrate that at the time the statement was made, the issuer was aware of facts that made it highly unlikely that the projection could be achieved.

F. "Disimplication" Theory

Professor Joseph A. Grundfest has suggested that, just as the courts have implied the existence of a private right of action under Rule 10b–5, the Commission may disimply such a right of action by redefining the element of a private Rule 10b–5 claim.[86] For example, Professor Grundfest has suggested that if the Commission should decide that if "projections deserve greater protection than is now afforded by Rule 175, then Rule 10b–5 can be amended to require a showing of 'knowing securities fraud,' demonstrating 'actual knowledge that the [projection] is false,' as a precondition for private recovery in a Rule 10b–5 action complaining of a falsely optimistic projection." [87]

[83] *See, e.g., Paramount Communications Inc.* v. *QVC Network, Inc.*, 637 A.2d 34, 46 n.17 (1994); *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (1993).

[84] The Association for Investment Management and Research ("AIMR") has expressed support for Commissioner Beese's proposal. *See* Letter from Michael S. Caccesse, Senior Vice President and General Counsel, AIMR, to Catherine Dixon dated October 7, 1994.

[85] *See, e.g.*, Item 12 of Forms S–2 and S–3 (17 CFR 239.12–13 (1994)); Items 11–13 of Form S–4 (17 CFR 239.25 (1994)); Item 12 of Forms F–2 and F–3, (17 CFR 239.32–33 (1994)); Items 11–14 of Form F–4 (17 CFR 239.36) (1994)).

[86] Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 Harv. L. Rev. 961 (1994).

[87] *Id.* at 1012 (footnotes omitted).

G. Reasonable Basis In Fact Proposal

The "Reasonable Basis In Fact" proposal, suggested by Jonathan Cuneo on behalf of the National Association of Securities and Commercial Attorneys ("NASCAT") protects forward-looking statements, whether written or oral and whether or not filed with the Commission, unless it can be shown that the statement was made without a reasonable basis in fact, was seriously undermined by existing facts, was not genuinely believed or was made other than in good faith.

The term "forward-looking statement" is defined to include any statement concerning future revenues, income, earnings, capital expenditures, dividends, products, services or lines of business, capital structure or other financial items, as well as management's plans or objectives for the future or the future economic performance of the corporation. The term also includes statements or assumptions underlying or relating to the foregoing.

H. "Opt-In" Proposal

The "Opt-In" proposal, suggested by Harvey Pitt, Karl Groskaufmanis and Gilbey Strub, would require issuers to make a formal election to "opt in[to]" a specified safe harbor disclosure regime.[88] Issuers opting in would be required to make forward-looking disclosure for a minimum of four quarters. Before a company may "opt out" of the safe harbor disclosure regime, it must provide notice 30 days before its next periodic report. The notice must detail the reasons for opting out, and statements therein would not be protected by the safe harbor. The company would be prohibited from opting back into the safe harbor disclosure regime for another year.

In order to be protected, the statements must have an adequate basis in fact, be issued in good faith and be consistent with any similar forward-looking information used contemporaneously by the issuer. For an issuer that has "opted in" to the safe harbor disclosure regime, only the Commission would be permitted to bring suit for projections that are made in bad faith or without a reasonable basis.

V. Solicitation of Public Comment

The Commission seeks comment on a number of issues. Commenters should discuss both the continuing effectiveness of the current safe harbors in accomplishing the primary goal of encouraging broader dissemination of forward-looking information to the investing public, and whether the Commission should consider any change to the current safe harbor. Would one or more of the proposals outlined above, any combination thereof, or any other proposal commenters may wish to identify, fulfill this goal more effectively without compromising investor protection? Do the concerns outlined in Part III above, either individually or in the aggregate, warrant revisiting and/or revising the existing safe harbor? Commenters should explain in detail all bases for their conclusion.

A. Types of Information Covered by a Safe Harbor

Assuming a safe harbor continues to be necessary or appropriate in the interests of the investing public, commenters should discuss what types of information should be eligible for safe harbor coverage.

Commenters supporting safe harbor coverage for forward-looking information should address the reasons justifying a distinction between forward-looking and historical information (either purely retrospective or based on estimate or opinion) with respect to the level of protection afforded to each. Does the fact that the person making the statements has unique knowledge concerning the basis for forward-looking statements, support or undercut this distinction? Commenters may wish to specify whether qualitative information, including but not limited to the type described above in Part I, is relevant to investors such that its disclosure should be encouraged. If so, should such information be included in the safe harbor? Should forward-looking information that is currently part of required audited financial information (such as loan-loss reserves, pension liabilities or contingent environmental liabilities) be included?[89] Are there certain types of forward-looking information that should be *per se* excluded from the safe harbor (*e.g.*, such as required audited information, or the "known trends and uncertainties" disclosure required by the MD&A)?

Should the safe harbor distinguish between oral and written statements, between statements filed with the Commission and non-filed statements, or between Securities Act required statements and others? Should the Commission require that any oral statement for which safe harbor coverage is sought be reduced to writing and filed with the Commission at or around the time that statement is first disseminated? If not, commenters should describe the legal and/or practical impediments, if any, to a contemporaneous filing requirement. Are there certain situations, *i.e.*, an initial public offering, in which safe harbor protection should be limited to statements made in Commission filings? Are commenters' views on these questions affected by the type of forward-looking information under consideration? For example, do different types of forward-looking information imply different degrees of reliability, *e.g.*, numerical financial projections as opposed to general statements of management's outlook? If so, should a broader safe harbor provide protection for a narrower category of information than does Rule 175 currently, or would differing safe harbors be warranted?

B. Voluntary Disclosure

Should the Commission continue its current general policy of voluntary disclosure of forward-looking information or should some or all of such information, given its significance, be mandated? If left voluntary, should any such information used in the offer or sale of securities by the issuer be required to be included in the prospectus? Would this be an appropriate solution to the issue of selective disclosure of key soft information during road shows? If not, commenters should explain this conclusion and discuss alternative approaches.

C. Scope of the Safe Harbor

Should the safe harbor be procedurally based or substantively based or both? For example, should the safe harbor be available only if the forward-looking information is reviewed by the board Audit Committee, or some other board level committee or committee of top management or an outside reviewer, or should the standard be a substantive one dependent on the reasonableness or other criteria of the information itself, regardless of the review process, or both?

D. Eligibility for and Conditions To Use of Safe Harbor

Should all issuers be eligible for the safe harbor or only certain issuers that satisfy specified conditions, such as sufficient reporting history and/or public float to ensure a market following? What other conditions might be appropriate? Should issuers be required to opt-in or opt-out of a safe harbor alone or in combination with the

[88] H. Pitt, K. Groskaufmanis and G. Strub, *Securities Law*, Nat. L. J., August 22, 1994, at B4.

[89] *See* Regulation S-K Item 101(c)(xii), 17 CFR 229.101(c)(xii); Industry Guide 3, Summary of Loan Loss Experience, 17 CFR 229.801 (1994).

foregoing? If so, what should the opt-in/opt-out conditions be? Should an issuer be required to specify that it is seeking the protection of the safe harbor by making a public filing, or by stating with regard to each safe harbor-eligible statement (where the issuer chooses the safe harbor's protection), that the statement is being made subject to the safe harbor, or by otherwise providing a "bespeaks caution" or other cautionary language? How could this condition be met (or policed) for oral statements or written statements made outside of Commission filings? Should the burden of proof be shifted from the plaintiff to the defendant corporation, generally or with respect to certain types of disclosures, *i.e.*, written statements outside Commission filings, oral statements, etc.? Should shareholders be permitted, or required to vote on the availability of any safe harbor? If so, should shareholders be permitted to approve or authorize more extensive safe harbors than those that would otherwise be available at the election of the issuer?

Should the safe harbor require disclosure of key assumptions because that information is uniquely within the control of the issuer? If assumptions were required to be disclosed along with the forward-looking information, how would this affect the judicial treatment of forward-looking cases? For example, if assumptions were required to be disclosed, would it make it easier for courts to evaluate motions to dismiss cases on a procedural motion and/or impose sanctions for the bringing of frivolous suits? Would this requirement be more or less effective coupled with any proposed litigation reforms?

Should the safe harbor be unavailable (or provide greater or absolute protection) if an insider, or specified insiders, traded (or no insider, or specified insiders, traded) within a specified period where the insiders(s) avoided a loss or made a gain (or failed to do so) based on the dissemination and subsequent correction of the forward-looking statement?

E. Elements of the Safe Harbor

Commenters should outline and discuss each element of an effective safe harbor. In this connection, should the safe harbor set forth a separate definition of materiality differing from that otherwise applicable under Commission rules and case law? Should the safe harbor impose and/or specify parameters for a duty to update or correct? Should the safe harbor require that a private plaintiff establish that he or she actually relied on forward-looking statements? Should a new definition of scienter be included in the safe harbor, *e.g.*, by eliminating recklessness as an element of proof? In answering this question, commenters should discuss separately implied and express rights of action, as well as Commission and private actions. Should a safe harbor include judicially developed concepts such as the "business judgment rule," "bespeaks caution" doctrine and/or any other judicial approaches discussed in the release? What treatment should the safe harbor give to information that the issuer does not disclose that may be relevant to evaluating the forward-looking statement?

F. Private Actions

Should the safe harbor distinguish between Commission enforcement action and private actions? Should the answer to the foregoing question depend on whether the underlying cause of action is express or implied? Would the Commission be able to compensate through enhanced enforcement for any reduction in the number of private suits in this area resulting from adoption of a particular safe harbor? How would any limitation on private actions, whether directly imposed or incorporated in a safe harbor, affect the Commission's longstanding policy of promoting private actions for fraud as a necessary supplement to Commission enforcement?

Should private litigants be required to pursue any antifraud claims arising from statements covered by a safe harbor in a nonjudicial forum—for example, through arbitration or some other form of alternate dispute resolution? Some commentators have suggested that a safe harbor should be adopted that would permit private antifraud actions to proceed only if the Commission first brings a successful enforcement action for fraud. Commenters are invited to address the merits of this suggestion and means of its implementation.

G. Issuer Duties Under the Safe Harbor

Should an issuer be required to update any forward-looking information? If so, for how long? Should the answer turn on whether disclosure is mandated by the Commission's disclosure requirements (*i.e.*, MD&A) or voluntary? Should an issuer be required to compare projections to actual results to provide information as to the reliability of the projections? Should an issuer be required to disclose and/or to file assumptions or the basis for a statement, as now required for issuers that elect to provide option grant values calculated under the option pricing models?[90]

Should the safe harbor require a registrant to correct forward-looking information rendered false or misleading after its initial disclosure? Should this duty extend only to information filed with the Commission?

Should a duty be imposed on issuers to update and/or correct forward-looking information disclosed by others? Should the safe harbor expressly provide that there is no duty to update and/or correct statements made by others? Should the safe harbor include a duty to update and/or correct statements only if the issuer becomes sufficiently "entangled" with the third party? If so, should the safe harbor delineate those acts or omissions that would support a finding of entanglement?

H. Registered Investment Companies

Is the forward-looking information that might be disclosed by registered investment companies, *i.e.*, projections of fund performance, inappropriate for the protection of the safe harbor because it is contingent on the performance of the securities markets, and therefore subject to greater uncertainty and frequency of change? Do any other characteristics of registered investment companies warrant separate treatment of their forward-looking disclosure for purposes of the safe harbor or, more generally, should such disclosure by registered investment companies be afforded any protection under a safe harbor? Comment also is specifically invited as to whether distinctions should be made among different kinds of registered investment companies (*e.g.*, open-end and closed-end, unit investment trust and management) for the purpose of encouraging forward-looking disclosure and providing safe harbor protection? In light of the fact that investment companies, unlike most other public companies, are not currently required to file current reports (Form 8–K) or quarterly reports (Form 10–Q), commenters should address how projections or other forward-looking information by investment companies would be revised or updated.

I. Multiple Safe Harbors

Some suggest that if private actions were to be reduced or eliminated, some issuers would be willing to make additional filings with the Commission, either in connection with current periodic reports or on a new disclosure form, and be subjected to greater

[90] *See* Item 402(c) of Regulation S–K, 17 CFR 229.402(c).

Commission oversight with lower thresholds for Commission enforcement actions and greater restrictions on information that can be provided orally. Other issuers may find these protections unnecessary, but would benefit from a safe harbor that simply made certain types of antifraud claims more difficult to prosecute successfully. Would it be reasonable to provide for or make available different types of safe harbors tailored to the particularized needs of differently situated issuers? Specifically, does the need for heightened protections of statements to analysts, whether oral or written, vary with the size and/or reporting history of the issuer? Should a different, more rigorous, safe harbor be made available to companies conducting an initial public offering, than that made available to companies with reporting histories? For example, are smaller issuers potentially affected differently than larger issuers so that different safe harbors should be available? Should the existing safe harbors in the Trust Indenture Act and the Public Utility Holding Company Act also be modified and, if so, why?

J. Possible Alternatives or Supplements to a Safe Harbor

Commenters also may wish to discuss whether there are alternatives to a safe harbor that would accomplish the same goal of promoting enhanced disclosure of forward-looking information. For example, are there reforms with regard to the content and/or presentation of soft information—whether within or outside of Commission filings—that would obviate the need for a safe harbor or the need to change the current safe harbor? Are there litigation reforms relating more broadly to the scope of antifraud liability under the securities laws that would obviate the need for the safe harbor? For example, could an issuer be presumed to have no liability for forward-looking statements otherwise eligible for the safe harbor unless the named plaintiff or group of plaintiffs represents at least a minimum percentage (say 10%) of the affected shareholder class? To the extent that the current safe harbor is strengthened in favor of issuers, should there be concomitant strengthening of other safeguards for investors? In this regard, commenters may wish to discuss the practicality of accomplishing any such reforms, and the likelihood that any such reforms would succeed. In lieu of or in addition to revising the existing safe harbor, should the Commission redefine one or more elements of a private Rule 10b-5 claim (*e.g.*, scienter, materiality and reliance)?

VI. Public Hearings

The issues addressed in this release have attracted the interest of investors, registrants, analysts and other market participants, as well as lawyers, accountants, federal legislators and academics. In view of this broad interest, as well as the importance and complexity of these issues, the Commission intends to authorize public hearings to be conducted after the close of the comment period. Among other matters, these hearings will explore the assumptions underlying the different views expressed by these and other members of the public. Testimony from witnesses will be elicited about the efficacy and potential effects of different safe harbor approaches, the costs and benefits of each approach, the design of any safe harbor and issues that may be raised by the comment letters. After these hearings, the Commission will determine whether to propose amendments to the rules regarding forward-looking information.

The hearings will begin at 10 a.m. on February 13, 1995 at 450 Fifth Street, NW., Washington, DC 20549 room 1C30. The agenda and format for the hearings, as well as the schedule of witnesses will be announced in a subsequent release to be issued shortly before the hearings commence.

Members of the public interested in testifying at the hearing should notify the Commission in writing of their intention to appear no later than December 31, 1994. The written notification should include a brief summary of the individual's intended testimony. Any person who does not wish to appear at the hearing may submit written testimony to be included in the hearing record. Such written testimony should be received by the Commission no later than January 11, 1995.

All written notifications, testimony and comment letters should be addressed in triplicate to Jonathan Katz, 450 Fifth Street, NW., Washington, DC 20549 and should refer to the comment file number of this release [S7–29–94]. All written submissions and a transcript of the hearings will be made available for public inspection and copying in the Commission's Public Reference Room. The hearings will be open to the public.

Dated: October 13, 1994.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

Appendix—Seasoned Issuer Proposal—Association of Publicly Traded Companies

(a) A forward-looking statement made by or on behalf of an issuer, or an omission to state a fact necessary to make the statement not misleading, shall not serve as the basis for a private action for damages under the Securities Act of 1933 or the Securities Exchange Act of 1934 if:

(1) The forward-looking statement is made in connection with a listed equity security or Nasdaq security for which transaction reports are required to be made on a mandatory real-time basis pursuant to an effective transaction reporting plan of an issuer which has been subject to the requirements of Section 12 or 15(d) of the Act and has filed all the material required to be filed pursuant to Sections 13, 14 or 15(d) for a period of six months;

(2) The issuer is not an issuer of penny stock as defined in Section 3(a)(51)(A) of the Act and Commission regulations;

(3) The issuer has not been convicted within five years prior to the making of the statement of any felony or misdemeanor in connection with the purchase or sale of any security or involving the making of any false filing with the Commission;

(4) The issuer is not subject to any order, judgement or decree of any court of competent jurisdiction temporarily or preliminarily restraining or enjoining, or is not subject to any order, judgement or decree of any court of competent jurisdiction, entered within five years prior to the making of the statement, permanently restraining or enjoining the issuer from engaging in or continuing any conduct or practice in connection with the purchase or sale of any security or involving the making of any false filing with the Commission;

(b) The term "forward-Looking statement" means:

(1) A statement containing a projection of revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure, growth rates, order rates, margin performance, price performance, backlog or other financial items whether stated in quantitative or qualitative terms;

(2) A statement of management's plans and objectives for future operations;

(3) A statement of future economic, product or business performance; or

(4) Disclosed statements of the assumptions underlying or relating to any of the statements described in paragraph (b) (1), (2) or (3) above.

Heightened Definition Proposal—Business Roundtable and National Association of Manufacturers

Rule 3b–6. Liability for Certain Statements by Issuers.

Preliminary Note

The Commission has recognized for many years that investors make decisions about the purchase and sale of securities with the future in mind. The market value of securities accordingly reflects the judgments of investors about the future economic performance of an issuer. Notwithstanding the inherent uncertainty of all statements about the future, investors regard forward-looking statements by issuers as an important source of relevant information. Forward-looking statements therefore make an important contribution to the efficiency of the U.S. securities markets, and the Commission wishes to encourage issuers to make such statements. At the same time, the Commission recognizes that issuers have a justified concern about becoming involved in litigation arising out of such statements. As the Supreme Court has observed, "even a complaint which by objective standards may have very little success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment. The very pendency of the lawsuit may frustrate or delay normal business activity of the defendant which is totally unrelated to the lawsuit." *Blue Chip Stamps v.* Manor Drug Store, 421 U.S. 723, 740 (1975).

In order to encourage the release by issuers of forward-looking information, the Commission has adopted this "safe harbor" rule. The Commission encourages the courts to apply the rule so as to implement the Commission's intent, i.e., to provide issuers with reasonable assurance regarding the standards that will govern their liability for such information while at the same time assessing liability where an issuer's conduct falls outside the rule and is otherwise actionable under the federal securities laws.

(a) *General Rule.* A statement within the coverage of paragraph (b) below which is made or alleged to be made by or on behalf of an issuer or by an outside reviewer retained by the issuer shall not serve as the basis of a violation of the Act unless (1) it relates to a misstatement or omission that is material within the meaning of paragraph (f), (2) it is made or omitted with *scienter* within the meaning of paragraph (g) and (3) the person challenging the statement (other than the Commission) relied on the statement within the meaning of paragraph (h).

(b) *Covered Statements.* This rule applies to the following statements:

(1) A forward-looking statement (as defined in paragraph (c) below), *provided* that:

(i) At the time such statements are made or reaffirmed, either the issuer is subject to the reporting requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and has complied with the requirements of Rule 13a–1 or 15d–1 thereunder, if applicable, to file its most recent annual report on Form 10–K, Form 10–KSB, Form 20–F, or Form 40–F; or, if the issuer is not subject to the reporting requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, the statements are made in a registration statement filed under the Securities Act of 1933, offering statement or solicitation of interest written document or broadcast script under Regulation A, or pursuant to Section 12 (b) or (g) of the Securities Exchange Act of 1934, and

(ii) The statements are not made by an issuer that is an investment company registered under the Investment Company Act of 1940; and

(2) Information which relates to (i) the effects of changing prices on the business enterprise, presented voluntarily or pursuant to Item 303 of Regulation S–K, or Regulation S–B, or Item 9 of Form 20–F, "Management's discussion and analysis of financial condition and results of operations," or Item 302 of Regulation S–K, "Supplementary financial information," or Rule 3–20(c) of Regulation S–X, or (ii) the value of proved oil and gas reserves (such as a standardized measure of discounted future net cash flows relating to proved oil and gas reserves as set forth in paragraphs 30–34 of Statement of Financial Accounting Standards No. 69) presented voluntarily or pursuant to Item 302 of Regulation S–K.

(c) *Forward-Looking Statement.* For the purpose of this rule, the term "forward-looking statement" shall mean and shall be limited to:

(1) A statement containing a projection of revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure or other financial items;

(2) A statement of management's plans and objectives for future operations, whether qualitative or quantitative, including plans for the development and delivery of new products or services;

(3) A statement of future economic performance; or

(4) Disclosed statements of the assumptions underlying or related to any of the statements described in paragraph (c)(1), (2), or (3) above.

(d) *Third-Party Statements.* A forward-looking statement shall be deemed not to have been made by or on behalf of an issuer for the purposes of paragraph (a) if it is made by any person other than the issuer or outside reviewer retained by the issuer and the issuer has not expressly and substantially contemporaneously endorsed or approved the statement. An issuer shall not be deemed to have any obligation to correct or update any statement made by a third party.

(e) *Duty to Update.* An issuer shall not be deemed to have any obligation to update a forward-looking statement made by it unless it has expressly and substantially contemporaneously undertaken to update such statement.

(f) *Materiality.* A forward-looking statement shall be deemed to be material only if it significantly alters the total mix of information made available regarding an issuer or its securities.

(g) *Scienter.* An issuer shall be deemed not to have acted with *scienter* with respect to a forward-looking statement unless the issuer had actual knowledge that the statement was false or knowingly and intentionally omitted to state a fact for the purpose of rendering such statement misleading. Evidence that (1) the issuer's officers, directors or employees traded contemporaneously in the issuer's securities or were the beneficiaries of compensation awards (whether or not related to the value of the issuer's securities) or (2) information tending to cast doubt on a statement's accuracy was in the possession of the issuer's employees below the level at which reporting decisions are made (or at such level but prior to the time such information could reasonably be expected to have been taken into account in making the statement), shall not in either case, or in both cases, in and of itself, be sufficient to support a finding of actual knowledge that a statement is false or misleading.

(h) *Reliance.* A forward-looking statement (or a statement derived therefrom) shall not be deemed to have been relied upon unless a person claiming such reliance had actual knowledge of and actually relied on such statement in connection with the purchase or sale of a security.

Bespeaks Caution Proposal—Professor Coffee

Proposed Rule 10b–22. *Liability for Certain Statements by Issuers*

(a) A purchaser or seller of securities shall not be entitled to rely in any action for fraudulent statement (as defined in paragraph (c) of this rule) upon a statement within the coverage of paragraph (b) of this rule.

(b) This rule applies to the following statements (with the burden being on the plaintiff to show that a statement asserted by an issuer or other defendant to fall within this paragraph does not in fact so qualify):

(1) A forward-looking statement (as defined in Rule 3b–6 under the Securities Exchange Act of 1934) made in a document filed with the Commission, or in an annual report meeting the requirements of Rules 14a–3 (b) and (c) or 14c–3 (a) and (b) under the Securities Exchange Act of 1934, a statement reaffirming such forward-looking statement subsequent to the date the document was filed or the annual report was made publicly available, or a forward-looking statement made prior to the date the document was filed or the date that the annual report was made publicly available if such statement is reaffirmed in a filed document or in an annual report made publicly available within a reasonable period after the making of such forward-looking statement;

(2) Information disclosed in a document filed with the Commission or in an annual report meeting the requirements of Rules 14a–3 (b) and (c) or 14c–3 (a) and (b) in response to (A) Item 303 of Regulation S–K or Regulation S–B with respect to liquidity, capital resources, and results of operations to the extent that such information identifies or describes the likely future impact of known trends or known demands, commitments, events or uncertainties or any expected changes with regard thereto, or (B) Item 302 of Regulation S–K or Rule 3–20(c) of Regulation S–X with regard to the affects of changing price levels on the business enterprise or the value of proved oil and gas reserves;

Provided that, in either case—

(i) Such statement contains or is closely accompanied by clear and specific cautionary language that explains in detail sufficient to inform a reasonable person of the level of risk associated with, or inherent in, the statement and that identifies the specific basis for such statement and for such level of risk;

(ii) At the time such statements are made or reaffirmed, the issuer is subject to the reporting requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 and has complied with the requirements of Rule 13a–l or 15d–l thereunder, as applicable, to file its most recent annual and quarterly reports on [form references omitted];

(iii) the statements are not made by or on behalf of an issuer that (A) is an investment company registered under the Investment Company Act of 1940, (B) has outstanding a "penny stock" (as defined in section 3(a)(50) of the Securities Exchange Act of 1934), or (C) would then be disqualified under Rule 262(a) from use of Regulation A under the Securities Act of 1933.

(c) For the purpose of this rule, the term fraudulent statement shall mean * * * [same as Rule 175(d)].

Fraudulent Intent Proposal—William Freeman, Esquire

The following language would be substituted into paragraph (a) of Rules 175 and 3b–6 (new language in boldface italics):

(a) A statement within the coverage of paragraph (b) of this section which is made by or on behalf of an issuer or by an outside reviewer retained by an issuer shall be deemed not to be a fraudulent statement (as defined in paragraph (d) of this section), unless it is shown that such statement was made or reaffirmed *recklessly or with actual intent to deceive. A forward looking statement will not be deemed to be made or reaffirmed recklessly unless it is shown that the issuer was, or had to be, aware of facts that made it highly unlikely that the projection could be achieved.*

Reasonable Basis in Fact—National Association of Securities and Commercial Law Attorneys ("NASCAT")

Liability for Certain Statements by Issuers

(a) A statement within the coverage of paragraph (b) of this rule which is made by or on behalf of an issuer (whether directly or by or through the means of any other person) or by an outside reviewer retained by the issuer shall be deemed to not be a fraudulent statement (as defined in paragraph (d) of this rule), unless it is shown that, at the time such statement was made or reaffirmed (i) facts seriously undermining its accuracy existed; (ii) it was not genuinely believed; (iii) it lacked a reasonable basis in fact; or (iv) it was issued other than in good faith.

(b) This rule applies to any forward-looking statement (as defined in paragraph (c) of this rule), whether written or oral.

(c) For the purpose of this rule the term "forward-looking statement" shall mean:

(1) Any statement concerning future revenues, income (loss), earnings (loss) per share, products, services or lines of business, capital expenditures, dividends, capital structure or other financial items;

(2) Any statement of management's plans or objectives for the future;

(3) Any statement of future economic performance; or

(4) Disclosed statements of the assumptions underlying or relating to any of the statements described in paragraphs (c) (1), (2) or (3) above.

(d) For the purpose of this rule the term "fraudulent statement" shall mean a statement which is an untrue statement of a material fact, a statement false or misleading with respect to any material fact, an omission to state a material fact necessary to make a statement not misleading, or which constitutes the employment of a manipulative, deceptive, or fraudulent device, contrivance, scheme, transaction, act, practice, course of business, or an artifice to defraud, as those terms are used in the Securities Act of 1933, the Securities Exchange Act of 1934 or the rules or regulations promulgated thereunder.

[FR Doc. 94–25814 Filed 10–18–94; 8:45 am]

BILLING CODE 8010–01–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 40 and 48

[PS–66–93]

RIN 1545–AS10

Gasoline and Diesel Fuel Excise Tax; Rules Relating to Gasohol; Tax on Compressed Natural Gas

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to gasohol blending and the taxes on diesel fuel and compressed natural gas. This document also proposes to remove obsolete excise tax regulations. The proposed regulations reflect and implement certain changes made by the Energy Policy Act of 1992 (the Energy Act) and the Omnibus Budget Reconciliation Act of 1993 (the 1993 Act). The proposed regulations relating to gasoline and diesel fuel affect certain blenders, enterers, industrial users, refiners, terminal operators, and throughputters. The proposed regulations relating to compressed natural gas affect persons that sell or buy compressed natural gas for use as a fuel in a motor vehicle or motorboat.

DATES: Written comments must be submitted by December 19, 1994. Outlines of comments to be presented at the public hearing scheduled for January 11, 1995, must be received by December 21, 1994.

ADDRESSES: Send submissions to: CC:DOM:CORP:T:R (PS–66–93), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:T:R (PS–66–93), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. The public hearing will be held in the IRS Auditorium, Seventh Floor, 7400 Corridor, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Frank Boland, (202) 622–3130; concerning submissions and the hearing, Carol Savage, at (202) 622–8452; (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act (44 U.S.C. 3504(h)). Comments on the collections of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, PC:FP, Washington, DC 20224.

The collections of information in this proposed regulation are in §§ 48.4041–21 and 48.6427–10. This information is required by the IRS to verify compliance with sections 4041 and 6427 and will be used to determine whether an amount of tax, credit, or payment has been computed correctly. The likely respondents are businesses and other for-profit organizations, including small businesses and organizations.

Estimated total annual reporting burden: 10 hours.

Estimated average annual burden per respondent: .1 hour.

Estimated number of respondents: 100

Estimated annual frequency of responses: On occasion.

Explanation of Provisions

Background

Effective January 1, 1994, the 1993 Act amends section 4081 to impose the diesel fuel tax in the same manner as the gasoline tax. Thus, tax is imposed on (1) the removal of gasoline and diesel fuel (collectively taxable fuel) from any refinery, (2) the removal of taxable fuel from any terminal, (3) the entry of taxable fuel into the United States for consumption, use, or warehousing, and (4) the sale of taxable fuel to an unregistered person unless there was a prior taxable removal, entry, or sale of the taxable fuel. However, tax does not apply to any entry or removal of taxable fuel transferred in bulk to a refinery or terminal if the persons involved (including the terminal operator) are registered by the IRS.

Conforming Amendments to Gasoline Regulations

On November 30, 1993, the IRS published in the **Federal Register** (58 FR 63069) temporary regulations under section 4081 relating to the imposition of the diesel fuel excise tax for diesel fuel that is removed at a terminal rack, removed from a refinery, entered into the United States, or blended outside of the bulk/transfer terminal system. Those rules are similar to the rules relating to the removal, entry, or blending of gasoline under §§ 48.4081–2 and 48.4081–3.

These proposed regulations generally consolidate the rules relating to gasoline and diesel fuel into a single set of rules applicable to all taxable fuel.

Compressed Natural Gas

Effective October 1, 1993, section 4041(a)(3) (added to the Internal Revenue Code by section 13241(e) of the 1993 Act) imposes a tax on compressed natural gas (CNG) that is sold for use or used as a fuel in a motor vehicle or motorboat.

The proposed regulations provide rules relating to the imposition of, and liability for, the tax on CNG. These rules are similar to the regulations relating to taxes on special motor fuels imposed by section 4041.

Gasohol; Tolerance Rule

The gasoline tax rate is 18.4 cents per gallon (the regular rate). However, a reduction from the regular rate is allowed for gasohol (a gasoline/alcohol mixture). Before January 1, 1993, section 4081(c) treated a mixture of gasoline and alcohol as gasohol only if at least 10 percent of the mixture was alcohol. The rate reduction under pre-1993 law was 5.4 cents per gallon for gasohol containing ethanol and 6 cents per gallon for gasohol containing alcohol other than ethanol. This was equivalent to a subsidy of 54 cents or 60 cents per gallon of alcohol used to produce gasohol.

Section 48.4081–6(b)(2) provides a special rule for the application of the "at least 10 percent" requirement by allowing a tolerance for mixtures that contain less than 10 percent alcohol but at least 9.8 percent alcohol. Under the tolerance rule, a portion of the mixture equal to the number of gallons of alcohol in the mixture multiplied by 10 is considered to be gasohol. Any excess liquid in the mixture is taxed at the regular rate. Absent the tolerance rule, pre-1993 law would have taxed the entire mixture at the regular rate.

The tolerance rule accommodates operational problems associated with the blending of gasohol. For example, blenders may fail to attain the required 10-percent alcohol level because the device used to meter the amount of gasoline or alcohol added to a tank truck is imprecise or because the high-speed gasoline or alcohol pump used does not shut off at the proper moment. Blenders cannot compensate for these errors by aiming for an alcohol content in excess of 10 percent because Environmental Protection Agency (EPA) rules do not authorize the sale of gasohol containing more than 10 percent alcohol.

Effective January 1, 1993, section 1920 of the Energy Act amended section 4081(c) to allow a reduction from the regular rate for mixtures containing at least 5.7 percent alcohol but less than 7.7 percent alcohol (5.7 percent gasohol) and mixtures containing at least 7.7 percent alcohol but less than 10 percent alcohol (7.7 percent gasohol). The 5.4- and 6-cents-per-gallon rate reductions were retained for mixtures containing at least 10 percent alcohol (10 percent gasohol) and were prorated for 5.7 percent and 7.7 percent gasohol to maintain the subsidy level of 54 cents or 60 cents per gallon, respectively, for ethanol or other alcohol that is mixed with gasoline.

The proposed regulations continue the present tolerance rule for mixtures that contain less than 10 percent alcohol but at least 9.8 percent alcohol. However, a similar rule is not extended to mixtures that contain less than 7.7 or 5.7 percent alcohol because blenders can compensate for any operational problems by aiming for an alcohol content above 7.7 or 5.7 percent without violating EPA rules.

Gasohol; Blender Credit or Payment

If a gasohol blender produces gasohol from gasoline that was taxed at the regular rate, section 6427(f) allows the gasohol blender to obtain a partial credit or payment relating to that tax. The proposed regulations provide the conditions under which a credit or payment under section 6427(f) will be allowed.

Gasohol; ETBE

The regulations under section 40 provide that alcohol used to produce ethyl tertiary butyl ether (ETBE) generally is treated as *alcohol* for purposes of the alcohol fuels credit when the ETBE is mixed with gasoline. The proposed regulations provide a similar rule with respect to alcohol used to produce ETBE for purposes of the reduced tax rates for gasohol.

For example, a gasoline/ETBE mixture would qualify as 5.7 percent gasohol if the mixture contains 12.7 percent ETBE and each gallon of ETBE is made from .45 gallon of alcohol.

Reliance on These Proposed Regulations

These regulations are being issued in proposed form to provide timely guidance to taxpayers and to allow interested parties appropriate opportunity to provide comments before issuance of final regulations. Although final regulations may include changes made, for example, in response to comments, taxpayers may rely on the proposed regulations until final regulations are issued. For example, alcohol used to produce ETBE is treated as *alcohol* for purposes of the gasohol tax rates.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments that are submitted timely (preferably a signed original and eight copies) to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Wednesday, January 11, 1995, at 1 p.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the building lobby more than 15 minutes before the hearing starts.

The rules of § 601.601(a)(3) apply to the hearing.

Persons that have submitted written comments by December 19, 1994 and want to present oral comments at the hearing must submit an outline of the topics to be discussed and the time to be devoted to each topic by December 21, 1994.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Frank Boland, Office of Assistant Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Parts 40 and 48

Excise taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 40 and 48 are proposed to be amended as follows:

PART 40—EXCISE TAX PROCEDURAL REGULATIONS

Paragraph 1. The authority citation for part 40 continues to read in part as follows:

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

Par. 2. Section 40.6302(c)-0 is amended by revising the entries for § 40.6302(c)-1(b)(1)(ii), (b)(5)(ii), (b)(6)(iii), (c)(2)(iv), and (c)(3)(iii) to read as follows:

§ 40.6302(c)–0 Table of contents.

* * * * *

§ 40.6302(c)–1 Use of Government depositaries.

* * * * *

(b) * * *

(1) * * *

(ii) Special rule for section 4081 tax deposits for September.

* * * * *

(5) * * *

(ii) Special rule for section 4081 tax deposits for September.

* * * * *

(6) * * *

(iii) Special rule for section 4081 tax deposits for September.

* * * * *

(c) * * *

(2) * * *

(iv) Modification for section 4081 tax deposits for September.

(3) * * *

(iii) Modification for section 4081 tax deposits for September.

* * * * *

Par. 3. Section 40.6302(c)-1 is amended as follows:

1. Paragraph (a) is amended by removing the parenthetical "(relating to taxes imposed on gasoline by section 4081)" from the last sentence and adding the parenthetical "(relating to section 4081 taxes)" in its place.

2. The heading for paragraph (b)(1)(ii) is revised.

3. Paragraph (b)(1)(ii) is amended by removing the parenthetical "(relating to gasoline)".

4. The heading for paragraph (b)(5)(ii) is revised.

5. Paragraph (b)(5)(ii) is amended by removing the parenthetical "(relating to gasoline)" from the first sentence.

6. Paragraph (b)(6)(ii) is amended by removing the parenthetical "(relating to deposits of gasoline tax for September)" and adding "(relating to deposits of section 4081 tax for September)" in its place.

7. The heading for paragraph (b)(6)(iii) is revised.

8. Paragraph (b)(6)(iii)(A), first sentence, is amended by removing the parenthetical "(relating to gasoline)".

9. Paragraph (b)(6)(iii)(B), first sentence, is amended by removing the parenthetical "(relating to gasoline)".

10. The heading for paragraph (c)(2)(iv) is revised.

11. Paragraph (c)(2)(iv)(A) is amended by removing the parenthetical "(relating to gasoline)".

12. The heading for paragraph (c)(3)(iii) is revised.

13. Paragraph (c)(3)(iii)(A) is revised by removing the parenthetical "(relating to gasoline)".

14. The revised provisions read as follows:

§ 40.6302(c)–1 Use of Government depositaries.

* * * * *

(b) * * *

(1) * * *

(ii) *Special rule for section 4081 tax deposits for September.* * * *

* * * * *

(5) * * *

(ii) *Special rule for section 4081 tax deposits for September.* * * *

* * * * *

(6) * * *

(iii) *Special rule for section 4081 tax deposits for September.* * * *

* * * * *

(c) * * *

(2) * * *

(iv) *Modification for section 4081 tax deposits for September.* * * *

(3) * * *

(iii) *Modification for section 4081 tax deposits for September.* * * *

* * * * *

Par. 4. In § 40.6302(c)–4, paragraph (a) is amended by removing the parenthetical "(relating to gasoline)".

Par. 5. In § 40.9999–1, *Example 3* is amended by removing the language "diesel fuel" each place it appears (including the heading) and adding "aviation fuel" in its place.

PART 48—MANUFACTURERS AND RETAILERS EXCISE TAXES

Par. 6. The authority citation for part 48 is amended by removing the entries for §§ 48.4041.21 and 48.4081–2; revising the entry for § 48.4081–4; and adding an entry in numerical order to read as follows:

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

Section 48.4081–4 also issued under 26 U.S.C. 4083(a)(2). * * *

Section 48.6427–10 also issued under 26 U.S.C. 6427(f).

Par. 7. Section 48.4041–21 is revised to read as follows:

§ 48.4041–21 Compressed natural gas.

(a) *Delivery of compressed natural gas into the fuel supply tank of a motor vehicle or motorboat*—(1) *Imposition of tax.* Tax is imposed on the delivery of compressed natural gas (CNG) into the fuel supply tank of the propulsion engine of a motor vehicle or motorboat unless tax was previously imposed on the CNG under paragraph (b) of this section.

(2) *Liability for tax.* If the delivery of the CNG is in connection with a sale, the seller of the CNG is liable for the tax imposed under paragraph (a)(1) of this section. If the delivery of the CNG is not in connection with a sale, the operator of the motor vehicle or motorboat, as the case may be, is liable for the tax imposed under paragraph (a)(1) of this section.

(b) *Bulk sales of CNG*—(1) *In general.* Tax is imposed on the sale of CNG that is not in connection with the delivery of the CNG into the fuel supply tank of the propulsion engine of a motor vehicle or motorboat if, by the time of the sale—

(i) The buyer has given the seller a written statement stating that the entire quantity of the CNG covered by the statement is for use as a fuel in a motor vehicle or motorboat; and

(ii) The seller has given the buyer a written acknowledgement of receipt of the statement described in paragraph (b)(1)(i) of this section.

(2) *Liability for tax.* The seller of the CNG is liable for the tax imposed under paragraph (b) of this section.

(c) *Exemptions*—(1) *In general.* The taxes imposed under this section do not apply to a delivery or sale of CNG for a use described in § 48.4082–4T(c)(1) through (5)(A) or (6) through (11). However, if the person otherwise liable for tax under this section is the seller of the CNG, the exemption under this section applies only if, by the time of sale, the seller has an unexpired certificate (described in this section) from the buyer and has no reason to believe any information in the certificate is false.

(2) *Certificate; in general.* The certificate to be provided by a buyer of CNG is to consist of a statement that is signed under penalties of perjury by a person with authority to bind the buyer, should be in substantially the same form as the model certificate provided in paragraph (c)(4) of this section, and should contain all information necessary to complete the model certificate. A new certificate must be given if any information in the current certificate changes. The certificate may be included as part of any business records normally used to document a sale. The certificate expires on the earliest of the following dates:

(i) The date one year after the effective date of the certificate (which may be no earlier than the date it is signed).

(ii) The date a new certificate is provided to the seller.

(iii) The date the seller is notified by the Internal Revenue Service or the buyer that the buyer's right to provide a certificate has been withdrawn.

(3) *Withdrawal of right to provide certificate.* The Internal Revenue Service may withdraw the right of a buyer of CNG to provide a certificate under this paragraph (c) if the buyer uses CNG to which a certificate applies in a taxable use. The Internal Revenue Service may notify any seller to whom the buyer has provided a certificate that the buyer's right to provide a certificate has been withdrawn.

(4) *Model certificate.*

CERTIFICATE OF PERSON BUYING CNG FOR A NONTAXABLE USE

(To support tax-free sales of CNG under section 4041 of the Internal Revenue Code.)

____

Name, address, and employer identification number of seller

______________ ("Buyer") certifies the

Name of buyer

following under penalties of perjury:

The CNG to which this certificate relates will be used in a nontaxable use.

This certificate applies to the following (complete as applicable):

If this is a single purchase certificate, check here ________ and enter:

1. Invoice or delivery ticket number ____________

2. ________ (number of MCFs)

If this is a certificate covering all purchases under a specified account or order number, check here ________ and enter:

1. Effective date ________________________

2. Expiration date ________________________

(period not to exceed 1 year after the effective date)

3. Buyer account or order number ____________

Buyer will not claim a credit or refund under section 6427 of the Internal Revenue Code for any CNG to which this certificate relates.

Buyer will provide a new certificate to the seller if any information in this certificate changes.

Buyer understands that if Buyer violates the terms of this certificate, the Internal Revenue Service may withdraw Buyer's right to provide a certificate.

Buyer has not been notified by the Internal Revenue Service that its right to provide a certificate has been withdrawn. In addition, the Internal Revenue Service has not notified Buyer that the right to provide a certificate has been withdrawn from a purchaser to which Buyer sells CNG tax free.

Buyer understands that the fraudulent use of this certificate may subject Buyer and all parties making any fraudulent use of this certificate to a fine or imprisonment, or both, together with the costs of prosecution.

____

Printed or typed name of person signing

____

Title of person signing

____

Employer identification number

____

Address of Buyer

____

Signature and date signed

(d) *Rate of tax.* The rate of the taxes imposed under this section is the rate prescribed by section 4041(a)(3).

(e) *Effective date.* This section is effective January 1, 1995.

Par. 8. Section 48.4081–0 is amended as follows:

1. The heading is revised.

2. The entries for §§ 48.4081–1 (c) and (k) and 48.4081–3(f) are revised.

3. The entries for the headings of §§ 48.4081–1, 48.4081–2, 48.4081–3, 48.4081–5, 48.4081–7, and 48.4081–8 are revised.

4. The revisions read as follows:

§ 48.4081–0 Taxable fuel; table of contents.

* * * * *

Section 48.4081–1 Taxable Fuel; Definitions

* * * * *

(c) Blended taxable fuel.

* * * * *

(k) Taxable fuel registrant.

* * * * *

Section 48.4081–2 Taxable Fuel; Tax on Removal at a Terminal Rack

* * * * *

Section 48.4081–3 Taxable Fuel; Taxable Events Other Than Removal at the Terminal Rack

* * * * *

(f) Tax on sales of taxable fuel within the bulk transfer/terminal system.

* * * * *

Section 48.4081–5 Taxable Fuel; Notification Certificate of Taxable Fuel Registrant

* * * * *

Section 48.4081–7 Taxable Fuel; Conditions for, and Reporting Relating to, Refunds of Taxable Fuel Tax Under Section 4081(e)

* * * * *

Section 48.4081–8 Taxable Fuel: Measurement

* * * * *

Par. 9. Section 48.4081–1 is amended as follows:

1. The heading for § 48.4081–1 is revised.

2. In paragraphs (a) and (b) the language "gasoline" is removed each place it appears and "taxable fuel" is added in its place.

3. Paragraph (c) is revised.

4. In paragraphs (d) through (h), the heading and text of paragraph (k), and paragraphs (m), (n), (p), (q), (r)(1), (s), (u), and (v) the language "gasoline" is removed each place it appears and "taxable fuel" is added in its place.

5. Paragraph (w) is revised.

6. The revised provisions read as follows:

§ 48.4081–1 Taxable fuel tax; definitions.

* * * * *

(c) *Blended taxable fuel*—(1) *In general.* Except as provided in paragraph (c)(2) of this section, *blended taxable fuel* is a mixture of—

(i) Taxable fuel with respect to which tax has been imposed under section 4041(a)(1) or 4081(a); and

(ii) Any substance with respect to which tax has not been imposed under section 4041(a)(1) or 4081(a), other than a minor amount of a product such as carburetor detergent or oxidation inhibitor.

(2) *Exception.* Gasohol (as defined in § 48.4081–6(b)(2)), is not *blended taxable fuel* if—

(i) The gasohol is a mixture of—

(A) Gasoline with respect to which tax was imposed under section 4081(a) at the gasohol production tax rate described in § 48.4081–6(e) (relating to gasohol) or with respect to which a valid claim is made under section 6427(f); and

(B) Alcohol (or alcohol and a minor amount of a product such as carburetor detergent or oxidation inhibitor); and

(ii) The mixture contains—

(A) At least 9.8 percent alcohol by volume, without rounding, but not more than 10 percent alcohol by volume, without rounding;

(B) 7.7 percent alcohol by volume, without rounding; or

(C) 5.7 percent alcohol by volume, without rounding.

* * * * *

(w) *Effective date.* This section is effective January 1, 1994.

Par. 10. Section 48.4081–2 is amended as follows:

1. The heading for § 48.4081–2 is revised.

2. The language "and" is added immediately following the semicolon at the end of paragraph (c)(3)(ii).

3. Paragraph (c)(3)(iii) is revised.

4. Paragraph (c)(3)(iv) is removed.

5. Paragraph (e) is revised.

6. The revised and added provisions read as follows:

§ 48.4081–2 Taxable fuel; tax on removal at a terminal rack.

* * * * *

(c) * * *

(3) * * *

(iii) Has no reason to believe that any information in the certificate is false.

* * * * *

(e) *Effective date.* This section is effective January 1, 1994.

Par. 11. Section 48.4081–3 is amended as follows:

1. The heading for § 48.4081–3 is revised.

2. In paragraphs (a), (d)(1), (d)(2)(i), and (d)(2)(ii)(A) the language "gasoline" is removed each place it appears and "taxable fuel" is added in its place.

3. Paragraph (d)(2)(iii) is revised.

4. The introductory text of paragraph (e)(1) is revised.

5. In paragraphs (e)(1)(i), (e)(1)(iii), and (e)(2)(i) the language "gasoline" is removed each place it appears and "taxable fuel" is added in its place.

6. Paragraph (e)(2)(ii) is revised.

7. In paragraph (e)(2)(iii) the language "gasoline" is removed each place it appears and "taxable fuel" is added in its place.

8. In paragraphs (f)(1) and (f)(2)(i) the language "gasoline" is removed each place it appears and "taxable fuel" is added in its place.

9. Paragraphs (f)(2)(ii) is revised.

10. In paragraphs (f)(2)(iii) and (g)(1) the language "gasoline" is removed each place it appears and "taxable fuel" is added in its place.

11. Paragraph (h) is revised.

12. The revised provisions read as follows:

§ 48.4081–3 Taxable fuel; taxable events other than removal at the terminal rack.

* * * * *

(d) * * *

(2) * * *

(iii) *Conditions for avoidance of liability.* A terminal operator is not liable for tax under this paragraph (d)(2) if, at the time of the bulk transfer, the terminal operator—

(A) Is a taxable fuel registrant;

(B) Has an unexpired notification certificate (described in § 48.4081–5) from the position holder; and

(C) Has no reason to believe that any information in the certificate is false.

* * * * *

(e) * * * (1) * * * Except as provided in § 48.4081–4 (relating to gasoline blendstocks), and § 48.4082–1T (relating to diesel fuel), a tax on taxable fuel is imposed if—

* * * * *

(2) * * *

(ii) *Conditions for avoidance of liability.* An owner of taxable fuel is not liable for tax under paragraph (e)(2)(i) of this section if, at the time the taxable fuel is removed from the pipeline or vessel, the owner of the taxable fuel—

(A) Is a taxable fuel registrant;

(B) Has an unexpired notification certificate (described in § 48.4081–5) from the operator of the terminal or refinery where the taxable fuel is received; and

(C) Has no reason to believe that any information in the certificate is false.

* * * * *

(f) * * *

(2) * * *

(ii) *Conditions for avoidance of liability.* A seller is not liable for tax under paragraph (f)(2)(i) of this section if, at the time of the sale, the seller—

(A) Is a taxable fuel registrant;

(B) Has an unexpired notification certificate (described in § 48.4081–5) from the buyer; and

(C) Has no reason to believe that any information in the certificate is false.

* * * * *

(h) *Effective date.* This section is effective January 1, 1994.

Par. 12. Section 48.4081–4 is amended as follows:

1. In paragraphs (b)(1)(i), (b)(2)(i), and (c)(1), the language "gasoline registrant" is removed each place it appears and "taxable fuel registrant" is added in its place.

2. The language "and" is added immediately following the semicolon at the end of paragraph (c)(2).

3. Paragraph (c)(3) is revised.

4. Paragraph (c)(4) is removed.

5. In paragraph (d), the language "gasoline registrant" is removed and "taxable fuel registrant" is added in its place.

6. Paragraph (f) is revised.

7. The revised provisions read as follows:

§ 48.4081–4 Gasoline tax; special rules for gasoline blendstocks.

* * * * *

(c) * * *

(3) Has no reason to believe that any information in the certificate is false.

* * * * *

(f) *Effective date.* This section is effective January 1, 1994.

Par. 13. Section 48.4081–5 is amended as follows:

1. The heading for § 48.4081–5 is revised.

2. In paragraph (a), the first sentence in paragraph (b)(1), and paragraph (b)(2), the language "gasoline" is removed each place it appears and "taxable fuel" is added in its place.

3. Paragraph (c) is revised.

4. The revised provisions read as follows:

§ 48.4081–5 Taxable fuel; notification certificate of taxable fuel registrant.

* * * * *

(c) *Effective date.* This section is effective January 1, 1994.

Par. 14. Section 48.4081–6 is amended as follows:

1. The heading for § 48.4081–6 is revised.

2. In the last sentence of paragraph (a), the parenthetical "(which has been taxed at a reduced rate)" is removed and "that has been taxed at a reduced rate" is added in its place.

3. Paragraph (b)(1)(iii) is added.

4. Paragraph (b)(2) is revised.

5. In paragraphs (c)(1)(i) and (ii), the language "gasoline registrant" is removed each place it appears and "taxable fuel registrant" is added in its place.

6. The language "and" is added immediately following the semicolon at the end of paragraph (c)(1)(ii)(A).

7. Paragraph (c)(1)(ii)(B) is revised.

8. Paragraph (c)(1)(ii)(C) is removed.

9. Paragraph (c)(2)(ii) is revised.

10. In the first sentence of paragraph (d), the language ", provided that the alcohol mixture credit allowed by section 40 has not been taken with respect to the alcohol in the gasohol" is added before the end thereof.

10a. Paragraph (e) is revised.

11. In paragraphs (f)(1)(i) and (iii), the language "10 percent" is removed each place it appears and "5.7 percent" is added in its place.

12. In paragraph (f)(4), *Example 1*, second sentence, the language "gasohol" is removed and "10 percent gasohol" is added in its place.

13. In paragraph (f)(4), *Example 2*, fourth sentence, the language "10 percent" is removed both places it appears and "5.7 percent" is added in its place.

14. Paragraphs (g)(2)(i) and (iii) are revised.

15. Paragraph (g)(2)(iv) is added.

16. Paragraph (h) is revised.

17. The added and revised provisions read as follows:

§ 48.4081–6 Taxable fuel; gasohol.

* * * * *

(b) * * *

(1) * * *

(iii) *Products derived from alcohol. Alcohol* includes alcohol described in paragraphs (b)(1)(i) and (ii) of this section that is chemically transformed in producing another product so that the alcohol is no longer present as a separate chemical in the other product, provided that there is no significant loss in the energy content of the alcohol. Thus, for example, alcohol described in paragraphs (b)(1)(i) and (ii) of this section that is used to produce ethyl tertiary butyl ether (ETBE) in a chemical reaction in which there is no significant loss in the energy content of the alcohol is treated as *alcohol* when the ETBE is mixed with gasoline.

(2) *Gasohol*—(i) *In general.* Gasohol is a mixture of gasoline and alcohol that is 10 percent gasohol, 7.7 percent gasohol, or 5.7 percent gasohol immediately after the mixture is blended. The determination of whether a particular mixture is 10 percent gasohol, 7.7 percent gasohol, or 5.7 percent gasohol is made on a batch-by-batch basis. A batch of gasohol is a discrete mixture of gasoline and alcohol. If a batch is splash blended, the contents of the batch typically correspond to a gasoline meter delivery ticket and an alcohol meter delivery ticket, each of which shows the number of gallons of liquid delivered into the mixture. In such case, the volume of each component in a batch (without adjustment for temperature) ordinarily is determined by the number of metered gallons shown on the delivery tickets for the gasoline and alcohol delivered. However, if a blender adds metered gallons of gasoline and alcohol to a tank already containing more than a minor amount of liquid (other than gasohol), the determination of whether a batch is gasohol and of its type will be made by taking into account the amount of alcohol and non-alcohol fuel contained in the liquid already in the tank. Ordinarily, any amount in excess of 0.5 percent of the capacity of the tank will not be considered minor.

(ii) *10 percent gasohol*—(A) *In general.* A batch of gasoline/alcohol mixture is 10 percent gasohol if it contains at least 10 percent alcohol by volume, without rounding.

(B) *Batches containing less than 10 percent but at least 9.8 percent alcohol.* If a batch of mixture contains less than 10 percent alcohol but at least 9.8 percent alcohol, without rounding, a portion of the batch is considered to be 10 percent gasohol. That portion equals the number of gallons of alcohol in the batch multiplied by 10. Any remaining liquid in the mixture is *excess liquid.* If tax was imposed on the excess liquid at the gasohol production rate (as defined in paragraph (e)(1) of this section), the excess liquid in the batch is considered to be gasoline with respect to which there is a failure to blend into gasohol for purposes of paragraph (g) of this section. Excess liquid is considered to be removed before the removal of the gasohol portion. If tax was imposed on the excess liquid at the rate of tax described in section 4081(a), a credit or refund under section 6427(f) is not allowed with respect to the excess liquid.

(iii) *7.7 percent gasohol.* A batch of gasoline/alcohol mixture is 7.7 percent gasohol if and only if it contains at least 7.7 percent, but less than 9.8 percent, alcohol by volume, without rounding.

(iv) *5.7 percent gasohol.* A batch of gasoline/alcohol mixture is 5.7 percent gasohol if and only if it contains at least 5.7 percent, but less than 7.7 percent, alcohol by volume, without rounding.

(v) *Examples.* This paragraph (b)(2) may be illustrated by the following examples. In these examples, a gasohol blender creates a gasoline/alcohol mixture by pumping a specified amount of gasoline into an empty tank. The blender then splash blends a specified amount of alcohol into gasoline.

Example 1. Mixtures containing exactly 10 percent alcohol. The applicable delivery tickets show that the mixture is made with 7200 metered gallons of gasoline and 800 metered gallons of alcohol. Accordingly, the mixture contains 10 percent alcohol (as determined based on the delivery tickets provided to the blender) and qualifies as 10 percent gasohol.

Example 2. Mixtures containing less than 10 percent alcohol but at least 9.8 percent alcohol. The applicable delivery tickets show that the mixture is made with 7205 metered gallons of gasoline and 795 metered gallons of alcohol. Because the mixture contains less than 10 percent alcohol, but more than 9.8 percent alcohol, (as determined based on the delivery tickets provided to the blender), 7950 gallons of the mixture qualify as 10 percent gasohol. If tax was imposed on the gasoline in the mixture at the gasohol production rate, the remaining 50 gallons of the mixture are treated as gasoline with respect to which there was a failure to blend into gasohol for purposes of paragraph (g) of this section. If tax was imposed on the gasoline in the mixture at the rate of tax described in section 4081(a), a credit or refund under section 6427(f) is allowed only with respect to 7155 gallons of gasoline.

Example 3. The applicable delivery tickets show that the mixture is made with 7550 metered gallons of gasoline and 450 metered gallons of alcohol. Because the mixture contains only 5.625 percent alcohol (as determined based on the delivery tickets provided to the blender), the mixture does not qualify as gasohol.

* * * * *

(c) * * *

(1) * * *

(ii) * * *

(B) Has no reason to believe that any information in the certificate is false.

(2) * * *

(ii) *Model certificate.*

CERTIFICATE OF REGISTERED GASOHOL BLENDER

(To support sales of gasoline at the gasohol production tax rate under section 4081(c) of the Internal Revenue Code)

____

Name, address, and employer identification number of seller

_______________ (Buyer) certifies the
Name of Buyer
following under penalties of perjury:

Buyer is registered as a gasohol blender with registration number _______________. Buyer's registration has not been suspended or revoked by the Internal Revenue Service. The gasoline bought under this certificate will be used by Buyer to produce gasohol (as defined in § 48.4081–6(b) of the Manufacturers and Retailers Excise Tax Regulations) within 24 hours after buying the gasoline.

Type of gasohol Buyer will produce (check one only):

________ 10% gasohol
________ 7.7% gasohol
________ 5.7% gasohol

If the gasohol the Buyer will produce will contain ethanol, check here: ________.

This certificate applies to the following (complete as applicable):

If this is a single purchase certificate, check here and enter:

1. Account number ____________________
2. Number of gallons ____________________

If this is a certificate covering all purchases under a specified account or order number, check here __________ and enter:

1. Effective date ____________________
2. Expiration date ____________________
(period not to exceed 1 year after the effective date)
3. Buyer account or order number ____________________

Buyer will not claim a credit or refund under section 6427(f) of the Internal Revenue Code for any gasoline covered by this certificate.

Buyer agrees to provide seller with a new certificate if any information on this certificate changes.

Buyer understands that Buyer's registration may be revoked if the gasoline covered by this certificate is resold or is used other than in Buyer's production of the type of gasohol identified above.

Buyer will not take the alcohol mixture credit under section 40(b) with respect to the alcohol in the gasohol to which this certificate relates.

Buyer understands that the fraudulent use of this certificate may subject Buyer and all parties making any fraudulent use of this certificate to a fine or imprisonment, or both, together with the costs of prosecution.

____
Printed or typed name of person signing

____
Title of person signing

____
Employer identification number

____
Address of Buyer

____
Signature and date signed

* * * * *

(e) *Tax rates*—(1) *Gasohol production tax rate.* The gasohol production tax rate is the applicable rate of tax determined under section 4081(c)(2)(A).

(2) *Gasohol tax rate.* The gasohol tax rate is the applicable alcohol mixture rate determined under section 4081(c)(4)(A).

* * * * *

(g) * * *

(2) *Failure to blend*—(i) *Imposition of tax.* Tax is imposed on the entry, removal, or sale of gasoline (including excess liquid described in paragraph (b)(2)(ii)(B) of this section) with respect to which tax was imposed at a gasohol production tax rate if—

(A) The gasoline was not blended into gasohol; or

(B) The gasoline was blended into gasohol but the gasohol production tax rate applicable to the type of gasohol produced is greater than the rate of tax originally imposed on the gasoline.

* * * * *

(iii) *Rate of tax.* The rate of tax imposed on gasoline described in paragraph (g)(2)(i)(A) of this section is the difference between the rate of tax applicable to gasoline not described in this section and the rate of tax previously imposed on the gasoline. The rate of tax imposed on gasoline described in paragraph (g)(2)(i)(B) of this section is the difference between the gasohol production tax rate applicable to the type of gasohol produced and the rate of tax previously imposed on the gasoline.

(iv) *Example.* The following example illustrates the rule of this paragraph (g)(2):

Example. (i) A registered gasohol blender bought gasoline in connection with a removal described in paragraph (c)(1)(ii) of this section. Based on the blender's certification (described in paragraph (c)(2) of this section) that the blender would produce 10 percent gasohol with the gasoline, tax at the gasohol production tax rate applicable to 10 percent gasohol was imposed on the removal.

(ii) The blender then produced a mixture by splash blending in a tank holding approximately 8000 gallons of mixture. The applicable delivery tickets show that the mixture was blended by first pumping 7220 metered gallons of gasoline into the empty tank, and then pumping 780 metered gallons of alcohol into the tank. Because the mixture contains 9.75 percent alcohol (as determined based on the delivery tickets provided to the blender) the entire mixture qualifies as 7.7 percent gasohol, rather than 10 percent gasohol.

(iii) Because the 7220 gallons of gasoline were taxed at the gasohol production tax rate applicable to 10 percent gasohol but the gasoline was blended into 7.7 percent gasohol, a failure to blend has occurred with respect to the gasoline. As the person that bought the gasoline in connection with the taxable removal, the blender is liable for the tax imposed under paragraph (g)(2)(i) of this section. The amount of tax imposed is the difference between—

(A) 7220 gallons times the gasohol production tax rate applicable to 7.7 percent gasohol; and

(B) 7220 gallons times the gasohol production tax rate applicable to 10 percent gasohol.

(iv) Because the gasohol does not contain exactly 7.7 percent alcohol, the benefit of the gasohol production tax rate with respect to the alcohol is less than the amount of the alcohol mixture credit under section 40(b) (determined before the application of section 40(c). Accordingly, the blender may be entitled to claim an alcohol mixture credit for the alcohol used in the gasohol. Under section 40(c), however, the amount of the alcohol mixture credit must be reduced to take into account the benefit provided with respect to the alcohol by the gasohol production tax rate.

(h) *Effective date.* This section is effective January 1, 1993.

Par. 15. Section 48.4081–7 is amended as follows:

1. The heading for § 48.4081–7 is revised.
2. In paragraphs (a), (b), (c), and (d), the language "gasoline" is removed each place it appears and "taxable fuel" is added in its place.
3. In paragraph (f), *Example 1*, paragraph (i), first and fourth sentences, and paragraph (ii), first and third sentences, the language "1993" is removed each place it appears and "1994" is added in its place.
4. Paragraph (g) is revised.
5. The revised provisions read as follows:

§ 48.4081–7 Taxable fuel; conditions for, and reporting relating to, refunds of taxable fuel tax under section 4081(e).

* * * * *

(g) *Effective date.* This section is effective in the case of taxable fuel with respect to which the first tax is imposed after December 31, 1993.

Par. 16. Section 48.4081–8 is revised to read as follows:

§ 48.4081–8 Taxable fuel; measurement.

(a) *In general.* For purposes of the tax imposed by section 4081, gallons of taxable fuel may be measured on the basis of—

(1) Actual volumetric gallons;

(2) Gallons adjusted to 60 degrees Fahrenheit; or

(3) Any other temperature adjustment method approved by the Commissioner.

(b) *Effective date.* This section is effective January 1, 1994.

§ 48.4221 [Removed]

Par. 17. Section 48.4221 is removed.

Par. 18. Section 48.4221–1 is amended as follows:

1. Paragraph (a) is revised.
2. Paragraph (b)(2)(iv) is amended by adding "and" at the end thereof.
3. Paragraph (b)(2)(v) is revised.
4. Paragraphs (b)(2)(vi) through (xii) are removed.
5. Paragraph (b)(3) is removed and paragraphs (b)(4) and (5) are redesignated as paragraphs (b)(3) and (4), respectively.
6. The revised provisions read as follows:

§ 48.4221–1 Tax free sales; general rule.

(a) *Application of regulations under section 4221*—(1) *In general.* The regulations under section 4221 provide rules under which the manufacturer, producer, or importer of an article subject to tax under chapter 32 (or the retailer of an article subject to tax under subchapter A or C of chapter 31) may sell the article tax free under section 4221.

(2) *Limitations.* The following restrictions must be taken into account in applying the regulations under section 4221:

(i) The exemptions under section 4221(a)(4) and (5) do not apply to the tax imposed by section 4064 (gas guzzler tax).

(ii) The exemptions under section 4221 do not apply to the tax imposed by section 4081 (gasoline and diesel fuel tax).

(iii) The exemptions under section 4221 do not apply to the tax imposed by section 4091 (aviation fuel tax). For rules relating to tax-free sales of aviation fuel, see section 4092 and the regulations thereunder.

(iv) The exemptions under section 4221 do not apply to the tax imposed by section 4121 (coal tax).

(v) The exemptions under sections 4221(a)(3), (4), and (5) do not apply to the tax imposed by section 4131 (vaccine tax). In addition, the exemption under section 4221(a)(2) applies to the vaccine tax only to the extent provided in § 48.4221–3(e) (relating to tax-free sales of vaccine for export).

(vi) The exemptions under section 4221(a) apply only in those cases where the exportation or use referred to is to occur before any other use.

(b) * * *

(2) * * *

(v) Section 4221(e)(3) relating to the sale of tires used on intercity, local, or school buses (see § 48.4221–8).

* * * * *

Par. 19. Section 48.4221–2 is amended by:

1. Removing from the first sentence of paragraph (a)(1) the language "(other than a tire or inner tube taxable under section 4071, which are given special treatment under sections 4221(e)(2) and (4), and §§ 48.4221–7 and 48.4221–8)" and adding "(other than a tire taxable under section 4071, which is given special treatment under section 4221(e)(2) and § 48.4221–7)" in its place.

2. Removing paragraph (a)(2) and redesignating paragraph (a)(3) as paragraph (a)(2).

3. Revising paragraph (b).

4. The revised provision reads as follows:

§ 48.4221–2 Tax-free sale of articles to be used for, or resold for, further manufacture.

* * * * *

(b) *Circumstances under which an article is considered to have been sold for use in further manufacture*—(1) An article shall be treated as sold for use in further manufacture if the article is sold for use by the buyer as material in the manufacture or production of, or as a component part of, another article taxable under chapter 32 of the Internal Revenue Code.

(2) An article is used as material in the manufacture or production of, or as a component of, another article if it is incorporated in, or is a part or accessory of, the other article when the other article is sold by the manufacturer. In addition, an article is considered to be used as material in the manufacture of another article if it is consumed in whole or in part in testing such other article. However, an article that is consumed in the manufacturing process other than in testing, so that it is not a physical part of the manufactured article, is not considered to have been used as material in the manufacture of, or as a component part of, another article.

* * * * *

§ 48.4221–5 [Amended]

Par. 20. Section 48.4221–5 is amended as follows:

1. Paragraph (c)(1) is amended by:

a. Removing the first sentence.

b. Removing the language "If a State or local government is not registered, the" and adding "The" in its place in the new first sentence.

2. In paragraph (d), the first sentence, is amended by:

a. Removing the language "(whether on the basis of a registration number or an exemption certificate)".

b. Removing the language "(such as gasoline that is" and adding "(such as tires that are" in its place.

§§ 48.4221–8, 48.4221–9, 48.4221–10 [Removed]

Par. 21. Sections 48.4221–8, 48.4221–9, and 48.4221–10 are removed.

§ 48.4221–11 [Redesignated § 48.4221–8]

Par. 22. Section 48.4221–11 is redesignated § 48.4221–8.

§ 48.4221–12 [Removed]

Par. 23. Section 48.4221–12 is removed.

Par. 24. In § 48.4222(a)–1, paragraphs (a) and (b) are revised to read as follows:

§ 48.4222(a)–1 Registration.

(a) *General rule.* Except as provided in § 48.4222(b)–1, tax- free sales under section 4221 may be made only if the manufacturer, first purchaser, and second purchaser, as the case may be, have been registered by the Internal Revenue Service.

(b) *Application instructions.* Application for registration under section 4222 must be made in accordance with instructions for Form 637 (or such other form as the Commissioner may designate).

* * * * *

Par. 25. In § 48.4222(b)–1, paragraph (a) is revised to read as follows:

§ 48.4222(b)–1 Exceptions to the requirement for registration.

(a) *State and local governments.* The Internal Revenue Service will not register state or local governments under section 4222. To establish the right to sell articles tax free to a state or local government, the manufacturer must obtain from a state or local government the information described in § 48.4221–5(c).

* * * * *

§ 48.6416(b)(2)–2 [Amended]

Par. 26. In § 48.6416(b)(2)–2, paragraphs (g) through (k) are removed.

§ 48.6416(g)–1 [Removed]

Par. 27. Section 48.6416(g)–1 is removed.

§§ 6424–0 through 48.6424–6 [Removed]

Par. 28. Section 48.6424–0 through 48.6424–6 are removed.

Par. 29. Section 48.6427–10 is added to read as follows:

§ 48.6427–10 Credit or payment with respect to gasoline used to produce gasohol.

(a) *Conditions to allowance of credit or payment.* A claim for credit or payment with respect to gasoline is allowed under section 6427(f) only if—

(1) The gasoline to which the claim relates was taxed at the aggregate rate of tax imposed by section 4081 without regard to section 4081(c);

(2) The claimant used the gasoline to produce gasohol (as defined in § 48.4081–6(b)(2)) that was sold or used in the claimant's trade or business; and

(3) The claimant has filed a timely claim for a credit or payment that contains the information required under paragraph (c) of this section.

(b) *Form of claim.* Each claim for a payment under section 6427(f) must be made on Form 8849 (or such other form as the Commissioner may designate) in accordance with the instructions for that form. Each claim for a credit under section 6427(f) must be made on Form 4136 (or such other form as the Commissioner may designate) in accordance with the instructions for that form.

(c) *Content of claim.* Each claim for credit or payment under section 6427(f) must contain the following information with respect to each batch of gasohol that contains the gasoline covered by the claim:

(1) The claimant's registration number, if the claimant is a registered gasohol blender (as defined in § 48.4081–6(b)(4)).

(2) The name, address, and employer identification number of the person that sold the claimant the gasoline.

(3) The date and location of the sale of the gasoline.

(4) The volume of the gasoline.

(5) The name, address, and employer identification number of the person that sold the claimant the alcohol.

(6) The date and location of the sale of the alcohol.

(7) The volume and type of the alcohol.

(8) In the case of a claim for a payment, a copy of the invoice or other record of sale relating to each purchase of alcohol.

(9) The written or typed name of the individual signing the claim and the telephone number of that individual.

(10) The amount of credit or payment claimed.

(d) *Time for filing claim.* For rules relating to the time for filing a claim under section 6427(f), see section 6427(i). A claim under section 6427(f) is not considered to be filed unless it contains all the information required by paragraph (c) of this section and received at the place required by the form.

(e) *Effective date.* This section is effective with respect to claims relating to gasohol produced after December 31, 1994.

Margaret Milner Richardson,

Commissioner of Internal Revenue.

[FR Doc. 94–25763 Filed 10–17–94; 8:45 am]

BILLING CODE 4830–01–P

ENVIRONMENTAL PROTECTION AGENCY

40 CFR Part 52

[VA20–2–6407b; FRL–5083–1]

Approval and Promulgation of Air Quality Implementation Plans; Virginia: Definition of VOC and Emission Control Areas

AGENCY: Environmental Protection Agency (EPA).

ACTION: Proposed rule.

SUMMARY: EPA proposes to approve the State Implementation Plan (SIP) revision submitted by the Commonwealth of Virginia on November 4, 1992. The revision consists of amendments to Virginia's definition of the term volatile organic compound (VOC) and administrative changes to Virginia's lists of emission control areas for VOC and oxides of nitrogen (NO_x). Virginia's November 4, 1992, SIP revision submittal also contained an emission statement regulation. The portion of Virginia's November 4, 1992, submittal pertaining to emission statements is the subject of a separate rulemaking action.

In the final rules section of this Federal Register, EPA is approving the Commonwealth's November 4, 1992, SIP revision as a direct final rule without prior proposal because the Agency views this as a noncontroversial SIP revision and anticipates no adverse comments. A detailed rationale for the approval is set forth in the direct final rule and technical support document (TSD) prepared for that rulemaking action. If no adverse comments are received in response to this proposed rule, no further activity is contemplated in relation to this rule. If EPA receives adverse comments, the direct final rule will be withdrawn and all public comments received will be addressed in a subsequent final rule based on this proposed rule. EPA will not institute a second comment period on this action. Any parties interested in commenting on this action should do so at this time.

DATES: Comments must be received in writing by November 18, 1994.

ADDRESSES: Written comments on this action should be addressed to Thomas J. Maslany, Director, Air, Radiation, and Toxics Division (3AT00), U.S. Environmental Protection Agency, Region III, 841 Chestnut Building, Philadelphia, Pennsylvania 19107. Copies of the documents relevant to this action are available for public inspection during normal business hours at the Air, Radiation, and Toxics Division, U.S. Environmental Protection Agency, Region III, 841 Chestnut Building, Philadelphia, Pennsylvania 19107; and the Virginia Department of Environmental Quality, 629 East Main Street, Richmond, Virginia, 23219.

FOR FURTHER INFORMATION CONTACT: Kathleen Stager, (215) 597–0545, at the EPA Regional Office listed.

SUPPLEMENTARY INFORMATION: See the information provided in the direct final action of the same title which is located in the rules and regulations section of this **Federal Register**.

List of Subjects in 40 CFR Part 52

Environmental protection, Air pollution control, Hydrocarbons, Intergovernmental relations, Nitrogen dioxide, Ozone.

Authority: 42 U.S.C. 7401–7671q.

Dated: August 4, 1994.

Peter H. Kostmayer,

Regional Administrator, Region III.

[FR Doc. 94–25684 Filed 10–18–94; 8:45 am]

BILLING CODE 6560–50–F

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40 CFR Part 70

[WI001; FRL–5093–8]

Proposed Interim Approval of the Operating Permits Program; Wisconsin

AGENCY: Environmental Protection Agency (EPA).

ACTION: Proposed interim approval.

SUMMARY: The EPA proposes interim approval of the Operating Permits Program submitted by the State of Wisconsin for the purpose of complying with Federal requirements which mandate that States develop, and submit to EPA, programs for issuing operating permits to all major stationary sources, and to certain other sources, with the exception of sources on Indian lands.

DATES: Comments on this proposed action must be received in writing by November 18, 1994.

ADDRESSES: Written comments should be addressed to: Carlton Nash, Chief, Regulation Development Section (AT–18J), EPA, 77 W. Jackson Boulevard, Chicago, Illinois 60604.

Copies of the State's submittal and other supporting information used in developing the proposed interim approval are available for inspection during normal business hours at the following location: EPA Region 5, Air and Radiation Division (AT–18J), 77 West Jackson Boulevard, Chicago, Illinois 60604.

FOR FURTHER INFORMATION CONTACT: Beth Valenziano, Permits and Grants Section (AT–18J), EPA, 77 W. Jackson Boulevard, Chicago, Illinois 60604, (312) 886–2703.

SUPPLEMENTARY INFORMATION:

I. Background and Purpose

A. Introduction

As required under title V of the Clean Air Act (Act) as amended (1990), EPA has promulgated rules which define the minimum elements of an approvable State operating permits program and the corresponding standards and procedures by which EPA will approve, oversee, and withdraw approval of State operating permits programs. See 57 FR 32250 (July 21, 1992). These rules are codified at title 40 of the Code of Federal Regulations (CFR) part 70. Title V requires States to develop, and submit to EPA, programs for issuing operating permits to all major stationary sources and to certain other sources.

The Act requires that States develop and submit these programs to EPA by November 15, 1993, and that EPA act to approve or disapprove each program within 1 year after receiving the submittal. The EPA's program review occurs pursuant to section 502 of the Act and the part 70 regulations, which together outline criteria for approval or disapproval. Where a program substantially, but not fully, meets the requirements of part 70, EPA may grant the program interim approval for a period of up to 2 years. If EPA has not fully approved a program by 2 years after the November 15, 1993 date, or by the end of an interim program, it must establish and implement a Federal program.